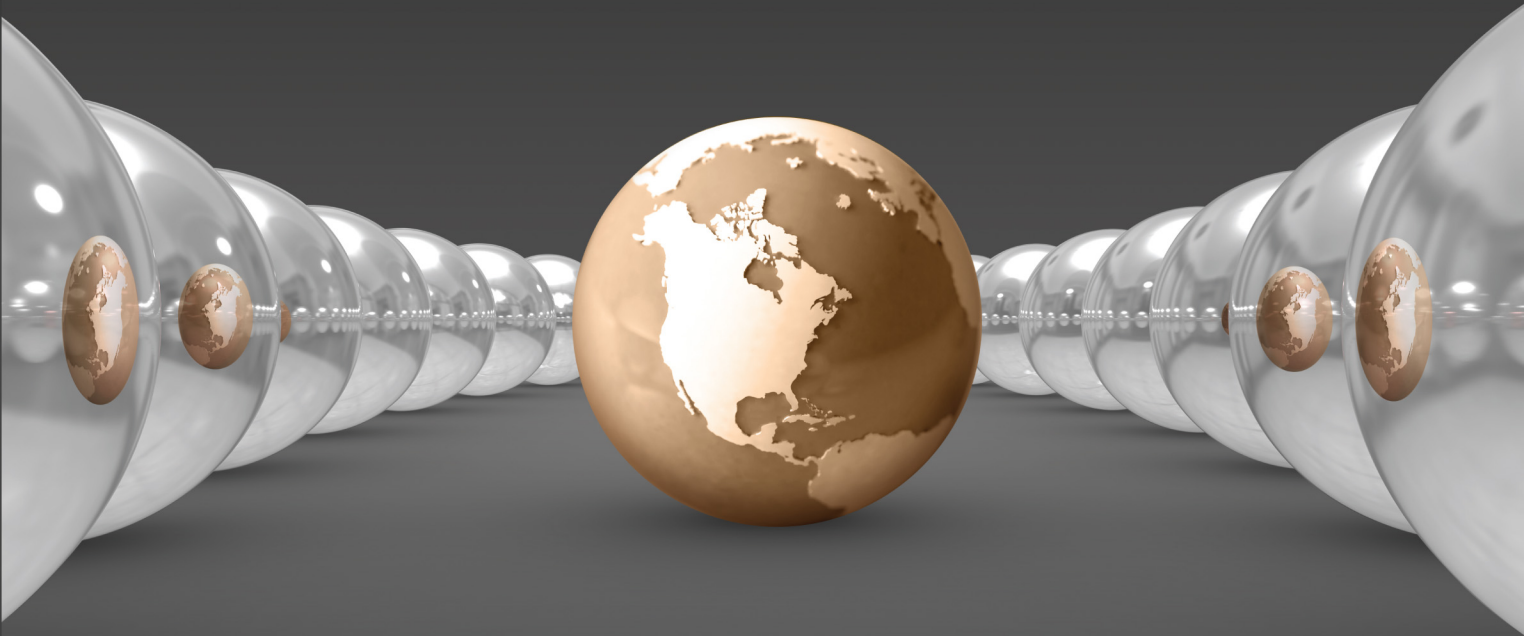


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Georgia Institute of Technology





STRATEGIC MANAGEMENT, FOURTH EDITION

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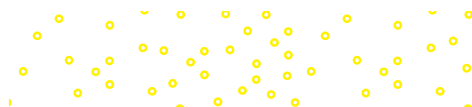
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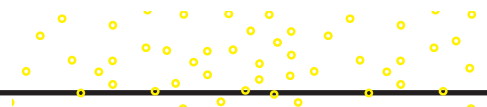


DEDICATION

To my eternal family for their love, support, and sacrifice: Kelley, Harris, Winston, Roman, Adelaide, Avery, and Ivy.

—FRANK T. ROTHARMEL





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Georgia Institute of Technology

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Frank’s research interests lie in the areas of strategy, innovation, and entrepreneurship. Frank has published over 30 articles in leading academic journals such as the *Strategic Management Journal*, *Organization Science*, *Academy of Management Journal*, *Academy of Management Review*, and elsewhere. Based on having published papers in the top 1 percent based on citations, *Thomson Reuters* identified Frank as one of the “world’s most influential scientific minds.” He is listed among the top-100 scholars based on impact over more than a decade in both economics and business. *Bloomberg Businessweek* named Frank one of Georgia Tech’s Prominent Faculty in its national survey of business schools. The Kauffman Foundation views Frank as one of the world’s 75 thought leaders in entrepreneurship and innovation.

Frank has received several recognitions for his research, including the Sloan Industry Studies Best Paper Award, the Academy of Management Newman Award, the Strategic Management Society Conference Best Paper Prize, the DRUID Conference Best Paper Award, the Israel Strategy Conference Best Paper Prize, and is the inaugural recipient of the Byars Faculty Excellence Award. Frank currently serves (or served) on the editorial boards of the *Strategic Management Journal*, *Organization Science*, *Academy of Management Journal*, *Academy of Management Review*, and *Strategic Organization*.

Frank regularly translates his research findings for wider audiences in articles in the *MIT Sloan Management Review*, *The Wall Street Journal*, *Forbes*, and elsewhere. To inform his research Frank has conducted extensive field work and executive training with leading corporations such as Amgen, Daimler, Eli Lilly, Equifax, GE Energy, GE Healthcare, Hyundai Heavy Industries (South Korea), Kimberly-Clark, Microsoft, McKesson, NCR, Turner (TBS), UPS, among others.

Frank has a wide range of executive education experience, including teaching in programs at GE Management Development Institute (Crotonville, NY), Georgia Institute of Technology, Georgetown University, ICN Business School (France), Politecnico di Milano (Italy), St. Gallen University (Switzerland), and the University of Washington. He received numerous teaching awards for excellence in the classroom including the GT-wide Georgia Power Professor of Excellence award.

When launched in 2012, Frank’s *Strategic Management* text received the McGraw-Hill 1st Edition of the Year Award in Business & Economics. His *Strategic Management* text has been translated into Mandarin, Korean, and Greek. Several of his case studies are Most Popular among the cases distributed by Harvard Business Publishing.

Frank held visiting professorships at the EBS University of Business and Law (Germany), Singapore Management University (Tommie Goh Professorship), and the University of St. Gallen (Switzerland). He is a member of the Academy of Management and the Strategic Management Society.

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PREFACE

The market for strategy texts can be broadly separated into two overarching categories: traditional, application-based and research-based. Traditional, application-based strategy books represent the first-generation texts with first editions published in the 1980s. The research-based strategy books represent the second-generation texts with first editions published in the 1990s. I wrote this book to address a needed new category—a third generation of strategy text that *combines* into one the student-accessible, application-oriented frameworks of the first-generation texts with the research-based frameworks of the second-generation texts.

The market response to this unique approach to teaching and studying strategy was overwhelmingly enthusiastic. Enthusiasm and support increased with each subsequent edition. I'm truly grateful for the sustained support.

To facilitate an enjoyable and refreshing reading experience that enhances student learning and retention, I synthesize and integrate strategy frameworks, empirical research, and practical applications with current real-world examples. This approach and emphasis on real-world examples offers students a learning experience that uniquely combines rigor and relevance. As Dr. John Medina of the University of Washington's School of Medicine and life long researcher on how the mind organizes information explains:

How does one communicate meaning in such a fashion that learning is improved? A simple trick involves the liberal use of relevant real-world examples, thus peppering main learning points with meaningful experiences. . . . Numerous studies show this works. . . . The greater the number of examples . . . the more likely the students were to remember the information. It's best to use real-world situations familiar to the learner. . . . Examples work because they take advantage of the brain's natural predilection for pattern matching. Information is more readily processed if it can be immediately associated with information already present in the brain. We compare the two inputs, looking for similarities and differences as we encode the new information. Providing examples is the cognitive equivalent of adding more handles to the door. [The more handles one creates at the moment of learning, the more likely the information can be accessed at a later date.] Providing examples makes the information more elaborative, more complex, better encoded, and therefore better learned.*

Strategic Management brings conceptual frameworks to life via examples that cover products and services from companies with which students are familiar, such as Facebook, Google, Tesla, Starbucks, Apple, McDonald's, Disney, Airbnb, and Uber. Liberal use of such examples aids in making strategy relevant to students' lives and helps them internalize strategy concepts and frameworks. Integrating current examples with modern strategy thinking, I prepare students with the foundation they need to understand how companies gain and sustain competitive advantage. I also develop students' skills to become successful leaders capable of making well-reasoned strategic decisions in a globalized and turbulent 21st century.

I'm pleased to introduce the new 4th edition of *Strategic Management*. My distinctive approach to teaching and transmitting strategy not only offers students a unique learning experience that combines theory and practice, but also provides tight linkages between concepts and cases. In this new 4th edition, I build upon the unique strengths of this product, and continue to add improvements based upon hundreds of insightful reviews and

*Source: Medina, J. (2014). *Brain Rules: 12 Principles for Surviving and Thriving at Work, Home, and School* (pp. 139–140). (Seattle: Pear Press).

important feedback from professors, students, and working professionals. The hallmark features of this text continue to be:

- Student engagement via practical and relevant application of strategy concepts using a holistic *Analysis, Formulation, and Implementation (AFI) Strategy Framework*.
- Synthesis and integration of empirical research and practical applications combined with relevant strategy material to focus on “*What is important?*” for the student and “*Why is it important?*”
- Emphasis on diversity by featuring a wide range of strategic leaders from different backgrounds and fields, not just in business, but also in entertainment, professional sports, and so forth.
- Coverage of an array of firms, including for-profit public (*Fortune 100*) companies, but also private companies (including startups) as well as non profit organizations. All of them need a good strategy!
- Global perspective, with a focus on competing around the world, featuring many leading companies from Asia, Europe, and Latin America, as well as the United States. I was fortunate to study, live, and work across the globe, and I attempt to bring this cosmopolitan perspective to bear in this text.
- Direct personal applications of strategy concepts to careers and lives to help internalize the content (including the popular myStrategy modules at the end of each chapter).
- Industry-leading digital delivery option (Create), adaptive learning system (Smart-Book), and online assignment and assessment system (Connect).
- Standalone module on *How to Conduct a Case Analysis*.
- High-quality **Cases**, well integrated with text chapters and standardized, high-quality teaching notes; there are two types of cases that come with this text:
 - 12 **ChapterCases** begin and end each chapter, framing the chapter topic and content.
 - 22 **MiniCases** (Part 4 of the book), all based on original research, provide dynamic opportunities for students to apply strategy concepts by assigning them as add-ons to chapters, either as individual assignments or as group work, or by using them for class discussion.

I have taken great pride in authoring all 12 ChapterCases, Strategy Highlights (2 per chapter, for a total of 24), and 22 MiniCases. This additional touch allows quality control and ensures that chapter content and cases use one voice and are closely interconnected. Both types of case materials come with sets of questions to stimulate class discussion or provide guidance for written assignments. The instructor resources offer sample answers that apply chapter content to the cases.

In addition to these in-text cases, 23 **full-length Cases**, with 20 of them (that is almost 90 percent!) authored or co-authored by me specifically to accompany this textbook, are available through McGraw-Hill’s custom-publishing Create™ program (www.McGrawHill-Create.com/Rothaermel). Full-length cases NEW to the 4th edition are:

- Uber
- Netflix
- Starbucks
- Disney
- Walmart
- SpaceX

Popular cases about Apple, Amazon, Facebook, McDonald's, Tesla, and Best Buy among several others are significantly updated and revised. Robust and structurally updated case teaching notes are also available and accessible through Create; financial data for these cases may be accessed from the Instructor Resource Center in the Connect Library.

What's New in the 4th Edition?

I have revised and updated the 4th edition in the following ways, many of which were inspired by conversations and feedback from the many users and reviewers of the prior editions.

OVERVIEW OF MAJOR CHANGES IN 4E:

- New A-head section on “Changes over Time: Entry Choices and Industry Dynamics” in Chapter 3.
- New A-head section on “The Value Chain and Strategic Activity Systems” in Chapter 4.
- New A-head section “Platform Strategy” in Chapter 7.
- New A-head section “Organizing for Innovation” in Chapter 11 (closed and open innovation).
- All new or updated and revised ChapterCases (including: Tesla, Sheryl Sandberg at Facebook, Airbnb, Uber vs. Lyft, IKEA, and Zappos).
- All new or updated and revised StrategyHighlights (two per chapter).
- New or fully updated and revised MiniCases (four new, 18 revised and updated).
- Fully updated and revised full-length cases, including most popular cases such as Apple, McDonald's, Best Buy, Amazon, Facebook, Delta Air Lines, Alphabet's Google, etc.

In detail:

CHAPTER 1

- New ChapterCase: “Tesla's Secret Strategy.”
- New Strategy Highlight: “Teach for America: How Wendy Kopp Inspires Future Leaders.”
- Improved chapter flow through moving the updated section on “Vision, Mission, and Values” into Chapter 1 (from Chapter 2).

CHAPTER 2

- New ChapterCase: “Sheryl Sandberg: Leaning in at Facebook.”
- Improved chapter flow through moving the updated section on “Stakeholder Strategy” into Chapter 2 (from Chapter 1).

CHAPTER 3

- New ChapterCase: “Airbnb: Disrupting the Hotel Industry.”
- New A-head section on “Changes over Time: Entry Choices and Industry Dynamics.”
- Improved chapter flow through moving the updated section on industry and firm effects into Chapter 3 (from Chapter 1).

CHAPTER 4

- New A-head section on “The Value Chain and Strategic Activity Systems.”
- New Strategy Highlight: “When Will P&G Play to Win Again?”

CHAPTER 5

- New section on “the Why, What, Who, and How of Business Models Framework.”
- Extended and updated discussion of business models to include new popular applications and examples, with a more in-depth discussion.
- Extended and updated discussion of competitive advantage and firm performance using the ongoing competition between Apple and Microsoft as an example throughout the chapter, including comparing the same two companies along different metrics and approaches to assess competitive advantage. Added a stronger dynamic element.

CHAPTER 6

- New section on the learning curve concept applied to Tesla’s manufacturing process with real-world data and graphic illustration.

CHAPTER 7

- New A-head section “Platform Strategy.”
- New Strategy Highlight “Standards Battle: Which Automotive Technology Will Win?”

CHAPTER 8

- Updated and revised ChapterCase featuring Amazon’s corporate strategy through vertical integration and diversification.
- Updated and expanded section on parent-subsidiary relationship, featuring GM and (former) subsidiaries Opel and Vauxhall in Europe.

CHAPTER 9

- New ChapterCase: “Little Lyft Gets Big Alliance Partners,” featuring the smaller ride-hailing competitor’s astute use of strategic alliances with strong partners such as GM and Alphabet’s Waymo to compete against Uber.
- New Strategy Highlight “How Tesla Used Alliances Strategically”.

CHAPTER 10

- New section on “Globalization 3.1: Retrenchment?”
- Updated and revised ChapterCase: “Sweden’s IKEA: The World’s Most Profitable Retailer,” highlighting IKEA’s strategy on competing in both developed and emerging economies across the world.
- New Exhibit 10.4 juxtaposing: “Advantages and Disadvantages of International Expansion”.
- Updated and revised Strategy Highlight: “Walmart Retreats from Germany, and Lidl Invades the United States,” highlighting how disruptors of the German grocery industry (Aldi and Lidl) are challenging Walmart on its home turf.

CHAPTER 11

- New A-head Section “Organizing for Innovation” (closed and open innovation).
- New Strategy Highlight: “Sony vs. Apple: Whatever Happened to Sony?”
- New Exhibit 11.11 juxtaposing: “Advantages and Disadvantages of Different Organizational Structures”.

CHAPTER 12

- Updated and revised ChapterCase: “Uber: Most Ethically Challenged Tech Company?” including co-founder and long-time CEO Travis Kalanick’s forced resignation in the wake of several ethics scandals.
- Updated and revised Strategy Highlight: “Why the Mild Response to Goldman Sachs and Securities Fraud?”

MINICASES

- Added four-new: Yahoo, IBM, Dollar Shave Club, and Disney.
- Updated and revised the most popular 18 MiniCases from the third edition.
- Stronger focus on non-U.S. firms, especially on global competitors from Asia and Europe.
- Stronger focus on U.S. companies competing in China and India, facing strong domestic competitors.

FULL-LENGTH CASES

- All cases—including the new and revised cases plus all cases from the previous editions that were authored by Frank T. Rothaermel—are available through McGraw-Hill Create: <http://www.mcgrawhillcreate.com/Rothaermel>.
- Added five new, author-written full-length Cases: Netflix, Starbucks, Uber, Walmart, and Disney.
- Added one new, full-length Case: SpaceX by David R. King
- Revised and updated the most popular cases including: Amazon, Apple, Alphabet’s Google, Best Buy, Facebook, McDonald’s, Tesla, Delta Air Lines, and UPS in India, among others.
- Updated and revised the popular case “The Movie Exhibition Industry” by Steve Gove.
- Case Strategic Financial Analyses (SFAs) include financial data in e-format for analysis.

CONNECT

Connect, McGraw-Hill’s online assignment and assessment system, offers a wealth of content for both students and instructors. Assignable activities include the following:

- **SmartBook**, one of the first fully adaptive and individualized study tools, provides students with a personalized learning experience, giving them the opportunity to practice and challenge their understanding of core strategy concepts. SmartBook has been extremely well received by strategy instructors across the globe. It allows the instructor to set up all assignments prior to the semester, to have them auto-released on pre-set dates, and to receive auto-graded progress reports for each student and the entire class. Students love SmartBook because they learn at their own pace, and it helps

them to study more efficiently by delivering an interactive reading experience through adaptive highlighting and review.

- **Interactive Application Exercises** (such as Whiteboard Animation video cases, MiniCase case analyses, click-and-drag activities, and new case exercises for Amazon, Apple, Tesla, McDonald's, Best Buy, and Facebook) that require students to apply key concepts and so to close the knowing and doing gap, while providing instant feedback for the student and progress tracking for the instructor.
- **Running case**, an activity that begins with a review of a specific company and its applied strategy using appropriate tools (e.g., PESTEL, Porter's five forces, VRIO, SWOT, and others). The analysis progresses from a broad perspective to the appropriate company-level perspective—i.e., from global to industry to strategic group to company and within a firm. Students will develop a complete strategy analysis for the company and consider several scenarios for improving the company's competitive advantage. The scenarios will include a financial analysis and justification and ultimately provide a specific recommendation. Connect provide a running case example for Hewlett-Packard (now HP Inc. and Hewlett Packard Enterprise).
- **Resources for financial analysis** (such as strategic financial ratios, templates for strategic financial analysis, and financial ratio reviews) that provide students with the tools they need to compare performance among firms and to refresh or extend their working knowledge of major financial measures in a strategic framework.

CREATE

- **CREATE**, McGraw-Hill's custom-publishing tool, is where you access the full-length cases (and Teaching Notes) that accompany *Strategic Management* (<http://www.mcgrawhillcreate.com/Rothaermel>). You can create customized course packages in print and/or digital form at a competitive price point.
- Through CREATE, you will be able to select from 20 author-written cases and 3 instructor-written cases that go specifically with the new 4th edition, as well as cases from Harvard, Ivey Darden, NACRA, and much more! You can: Assemble your own course, selecting the chapters, cases (multiple different formats), and readings that will work best for you. Or choose from several ready-to-go, author-recommended complete course solutions, which include chapters, cases, and readings, pre-loaded in CREATE. Among the pre-loaded solutions, you'll find options for undergrad, MBA, accelerated, and other strategy courses.

INSTRUCTOR RESOURCES

Located in the Connect Library under the **Instructor's Resources** tab, instructors will find tested and effective tools to support teaching:

- The updated and revised **Teacher's Resource Manual (TRM)** includes thorough coverage of each chapter, as well as guidance for integrating Connect—all in a single resource. Included in this newly combined TRM, which retains favorite features of the previous edition's Instructor's Manual, is the appropriate level of theory, framework, recent application or company examples, teaching tips, PowerPoint references, critical discussion topics, and answers to end-of-chapter exercises.
- The **PowerPoint (PPT)** slides, available in an accessible version for individuals with visual impairment, provide comprehensive lecture notes, video links, and company

examples not found in the textbook. Options include instructor media-enhanced slides as well as notes with outside application examples.

- The **Test Bank** includes 100–150 questions per chapter, in a range of formats and with a greater-than-usual number of comprehension, critical-thinking, and application (or scenario-based) questions. It's tagged by learning objectives, Bloom's Taxonomy levels, and AACSB compliance requirements. Many questions are new, and especially written for the new 4th edition.
- The **Video Guide** includes video links that relate to concepts from chapters. The video links include sources such as Big Think, Stanford University's Entrepreneurship Corner, The McKinsey Quarterly, ABC, BBC, CBS, CNN, ITN/Reuters, MSNBC, NBC, PBS, and YouTube.

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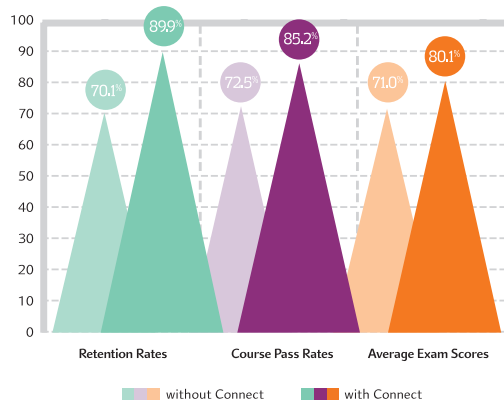
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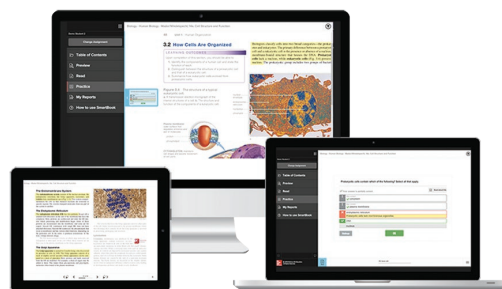


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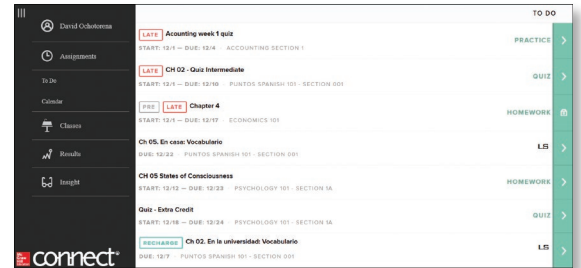


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PART

1 Analysis

CHAPTER 1 What Is Strategy?

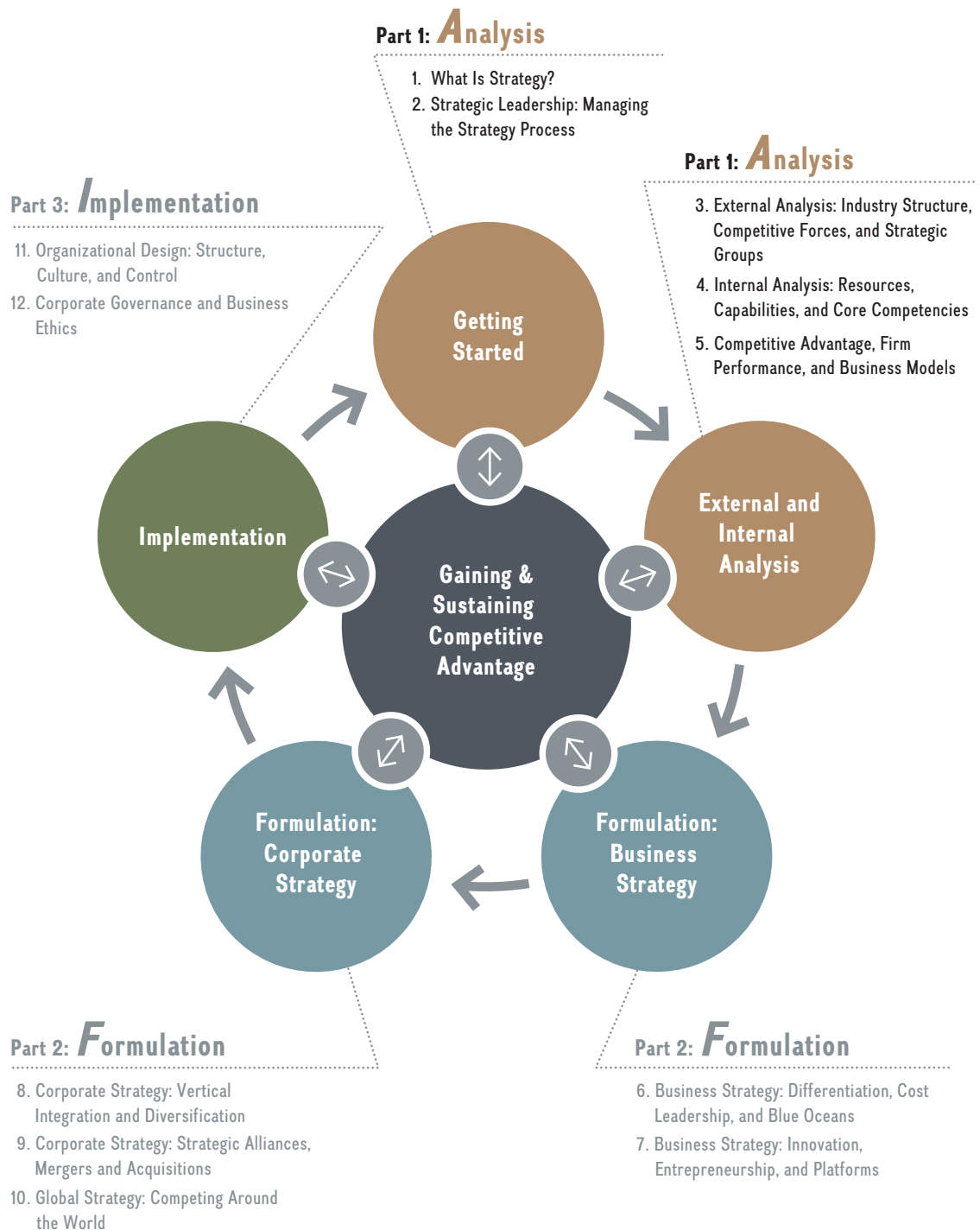
CHAPTER 2 Strategic Leadership: Managing the Strategy Process

CHAPTER 3 External Analysis: Industry Structure, Competitive Forces, and Strategic Groups

CHAPTER 4 Internal Analysis: Resources, Capabilities, and Core Competencies

CHAPTER 5 Competitive Advantage, Firm Performance, and Business Models

The AFI Strategy Framework



CHAPTER 1 What Is Strategy?

Chapter Outline

- 1.1** What Strategy Is: Gaining and Sustaining Competitive Advantage
What Is Competitive Advantage?
- 1.2** Vision, Mission, and Values
Vision
Mission
Values
- 1.3** The AFI Strategy Framework
- 1.4** Implications for Strategic Leaders

Learning Objectives

- LO 1-1** Explain the role of strategy in a firm's quest for competitive advantage.
- LO 1-2** Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.
- LO 1-3** Describe the roles of vision, mission, and values in a firm's strategy.
- LO 1-4** Evaluate the strategic implications of product-oriented and customer-oriented vision statements.
- LO 1-5** Justify why anchoring a firm in ethical core values is essential for long-term success.
- LO 1-6** Explain the AFI strategy framework.

Tesla's Secret Strategy

IN 2017, TESLA INC.—an American manufacturer of all-electric cars—boasted a market capitalization¹ of over \$60 billion, an appreciation of more than 1,400 percent over its initial public offering price in 2010. How can a California startup achieve a market valuation that exceeds that of GM, the largest car manufacturer in the world, making some 10 million vehicles a year? The answer: Tesla's Secret Strategy. In a blog entry on Tesla's website in the summer of 2006, Elon Musk, Tesla's co-founder and CEO, explained the startup's master plan:²

1. Build sports car.
2. Use that money to build an affordable car.
3. Use *that* money to build an even more affordable car.
4. While doing above, also provide zero-emission electric power generation options.
5. Don't tell anyone.

Let's see if Tesla stuck to its strategy. In 2008, Tesla introduced its first car: the Roadster, a \$110,000 sports coupe with faster acceleration than a Porsche or a Ferrari. Tesla's first vehicle served as a prototype to demonstrate that electric vehicles can be more than mere golf carts. Tesla thus successfully completed Step 1 of the master plan.

In Step 2, after selling some 2,500 Roadsters, Tesla discontinued its production in 2012 to focus on its next car: the Model S, a four-door family sedan, with a base price of \$73,500 before tax credits. The line appeals to a somewhat larger market and thus allows for larger production runs to drive down unit costs. The Model S received an outstanding market reception. It was awarded not only the 2013 Motor Trend Car of the Year, but also

received the highest score of any car ever tested by Consumer Reports (99/100). Tesla manufactures the Model S in the Fremont, California, factory that it purchased from Toyota. By the end of 2016, it had sold some 125,000 of the Model S worldwide.

Hoping for an even broader customer appeal, Tesla also introduced the Model X, a crossover between an SUV and a family van with futuristic falcon-wing doors for convenient access to second- and third-row seating. The \$100,000 starting sticker price of the Model X is quite steep, however; thus limiting mass-market appeal. Technical difficulties with its innovative doors delayed its launch until the fall of 2015.

Tesla has now reached Step 3 of its master plan. In 2017, Tesla delivered the company's newest car: the

Model 3, an all-electric compact luxury sedan, with a starting price of \$35,000. Tesla received some 375,000 preorders within three months of unveiling its model. Many of the want-to-be Tesla owners stood in line overnight, eagerly awaiting the opening of the Tesla stores to put down a \$1,000 deposit to secure a spot on the waiting list for the Model 3, a car they had never even seen, let alone taken for a

test drive. By the time Tesla delivered the first 30 cars of its new Model 3 (to Tesla employees for quality testing and appreciation of their hard work), the California car maker had received over 500,000 preorders. This customer enthusiasm amounted to \$500 million in interest-free loans for Tesla. The Model 3 was slated for delivery by late 2017. Tesla hoped to sell 500,000 total vehicles by the end of 2018. To accomplish this ambitious goal, Musk also promised that Tesla would increase its annual production from 50,000 in 2015 to 1 million vehicles a year by 2020.



Tesla's Model X with falcon wing doors. ©Bloomberg/Getty Images

Step 4 of Musk's master plan for Tesla aims to provide zero-emission electric power generation options. To achieve this goal, Tesla acquired SolarCity, a solar energy company, for more than \$2 billion in the fall of 2016. This joining creates the world's first fully integrated clean-tech energy company by combining solar power, power storage, and transportation. A successful integration of Tesla and

SolarCity, where Musk is also chairman and an early investor, would allow completion of Step 4 of Tesla's master plan.

Step 5: "Don't tell anyone"—thus the ChapterCase title "Tesla's Secret Strategy."³

You will learn more about Tesla by reading this chapter; related questions appear in "ChapterCase 1 / Consider This"

 **WHY IS TESLA SO SUCCESSFUL?** In contrast, the big-three U.S. automakers—Ford, GM, and Chrysler—struggled during the first decade of the 21st century, with both GM and Chrysler filing for bankruptcy protection.

If once-great firms can fail, why is any company successful? What enables some firms to gain and then sustain their competitive advantage over time? How can managers influence firm performance? These are the big questions that define strategic management. Answering these questions requires integrating the knowledge you've obtained in your studies of various business disciplines to understand what leads to superior performance, and how you can help your organization achieve it.

Strategic management is the integrative management field that combines *analysis*, *formulation*, and *implementation* in the quest for competitive advantage. Mastery of strategic management enables you to view an organization such as a firm or a nonprofit outfit in its entirety. It also enables you to think like a general manager to help position your organization for superior performance. The *AFI strategy framework* embodies this view of strategic management. It will guide our exploration of strategic management through the course of your study.

In this chapter, we lay the groundwork for the study of strategic management. We'll introduce foundational ideas about strategy and competitive advantage. We then move from thinking about why strategy is important to considering the role an organization's vision, mission, and values play in its strategy. Next, we take a closer look at the components of the AFI framework and provide an overview of the entire strategic management process. We conclude this introductory chapter, as we do with all others in this text, with a section titled *Implications for Strategic Leaders*. Here we provide practical applications and considerations of the material developed in the chapter. Let's begin the exciting journey to understand strategic management and competitive advantage.

strategic management An integrative management field that combines analysis, formulation, and implementation in the quest for competitive advantage.

1.1 What Strategy Is: Gaining and Sustaining Competitive Advantage

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance *relative* to competitors.⁴ To achieve superior performance, companies compete for resources: New ventures compete for financial and human capital, existing companies compete for profitable growth, charities compete for donations, universities compete for the best students and professors, sports teams compete for championships, while celebrities compete for media attention.

As highlighted in the ChapterCase, Tesla, a new entrant in the automotive industry, is competing with established U.S. companies such as GM, Ford, and Chrysler and also with foreign automakers Toyota, Honda, Mercedes, and BMW, among others, for customers. In any

LO 1-1

Explain the role of strategy in a firm's quest for competitive advantage.

strategy The set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors.

competitive situation, a **good strategy** enables a firm to achieve superior performance relative to its competitors. This leads to the question: What is a good strategy?

1. A *diagnosis* of the competitive challenge. This element is accomplished through *analysis* of the firm's external and internal environments (Part 1 of the AFI framework).
2. A *guiding policy* to address the competitive challenge. This element is accomplished through strategy *formulation*, resulting in the firm's corporate, business, and functional strategies (Part 2 of the AFI framework).
3. A *set of coherent actions* to implement the firm's guiding policy. This element is accomplished through strategy *implementation* (Part 3 of the AFI framework).

Let's revisit ChapterCase 1 to see whether Tesla, Inc. is pursuing a good strategy. Tesla appears to be performing quite well when considering indicators such as stock appreciation, where it outperforms its competitors by a wide margin. The high appreciation of Tesla stock points to investors' expectations of future growth. By other measures, such as generating profits, Tesla underperforms compared to established car companies. Losses are common for startups early on, especially if the business requires large upfront investments such as building new factories, which Tesla was required to do. What we can say at this point is that Tesla seems to be starting with a promising strategy and is in the process of gaining a competitive advantage. But can Tesla sustain its advantage over time? Let's use the three elements of a good strategy to assess how Tesla CEO Elon Musk could turn an early lead into a sustainable competitive advantage.

THE COMPETITIVE CHALLENGE. A good strategy needs to start with a clear and critical diagnosis of the competitive challenge. Musk, Tesla's co-founder and CEO, describes himself as an "engineer and entrepreneur who builds and operates companies to solve environmental, social, and economic challenges."⁵ Tesla was founded with the vision to "accelerate the world's transition to sustainable transport."⁶

To accomplish this mission, Tesla must build zero-emission electric vehicles that are attractive and affordable. Beyond achieving a competitive advantage for Tesla, Musk is working to set a new standard in automotive technology. He hopes that zero-emission electric vehicles will one day replace gasoline-powered cars.

Tesla's competitive challenge is sizable: To succeed it must manufacture attractive and affordable vehicles using its new technology, which will compete with traditional cars running on gasoline. It also needs the required infrastructure for electric vehicles, including a network of charging stations to overcome "range anxiety"⁷ by consumers; many mass-market electric vehicles cannot drive as far on one charge as gasoline-powered cars can with a full tank of gas. Gas stations can be found pretty much on any corner in cities and every couple of miles on highways.⁸

A GUIDING POLICY. After the diagnosis of the competitive challenge, the firm needs to formulate an effective guiding policy in response. The formulated strategy needs to be consistent, often backed up with *strategic commitments* such as sizable investments or changes to an organization's incentive and reward system—big changes that cannot be easily reversed. Without consistency in a firm's guiding policy, employees become confused and cannot make effective day-to-day decisions that support the overall strategy. Without consistency in strategy, moreover, other stakeholders, including investors, also become frustrated.

To address the competitive challenge, Tesla's current guiding policy is to build a cost-competitive mass-market vehicle such as the new Model 3 (this is also Step 3 in Tesla's "Secret Strategy," as discussed in the ChapterCase). Tesla's formulated strategy is consistent with its mission and the competitive challenge identified. It also requires significant strategic commitments such as Tesla's \$5 billion investment in a new lithium-ion battery

Good strategy A strategy is good when it enables a firm to achieve superior performance. It consists of three elements: (1) a diagnosis of the competitive challenge; (2) a guiding policy to address the competitive challenge; and (3) a set of coherent actions to implement a firm's guiding policy.

plant in Nevada, the so-called Gigafactory. Batteries are the most critical component for electric vehicles. To accomplish this major undertaking, Tesla has partnered with Panasonic of Japan, a world leader in battery technology.

COHERENT ACTIONS. Finally, a clear guiding policy needs to be implemented with a set of coherent actions. Tesla appears to implement its formulated strategy with actions consistent with its diagnosis of the competitive challenge. To accomplish building a cost-competitive mass-market vehicle, Tesla must benefit from *economies of scale*, which are decreases in cost per vehicle as output increases. To reap these critical cost reductions, Tesla must ramp up its production volume. This is a huge challenge: Tesla aims to increase its production output by some 20 times, from 50,000 cars built in 2015 to 1 million cars per year by 2020. Tesla's retooling of its manufacturing facility in Fremont, California, to rely more heavily on cutting-edge robotics as well as its multibillion-dollar investment to secure an uninterrupted supply of lithium-ion batteries are examples of actions coherent with Tesla's formulated strategy. At the same time, Tesla is further building out its network of charging stations across the United States and globally. To fund this initiative, it announced that using the company's charging network will no longer be free for new Tesla owners.

To accomplish the lofty goal of making zero-emission electric motors the new standard in automotive technology (rather than gas-powered internal combustion engines), Tesla decided to make its proprietary technology available to the public. Musk's hope is that sharing Tesla's patents will expand the overall market size for electric vehicles as other manufacturers, such as BMW with its i3 line of vehicles, can employ Tesla's technology.

In review, to create a good strategy, three steps are crucial. First, a good strategy defines the competitive challenges facing an organization through a critical and honest assessment of the status quo. Second, a good strategy provides an overarching approach on how to deal with the competitive challenges identified. The approach needs to be communicated in policies that provide clear guidance for employees. Last, a good strategy requires effective implementation through a coherent set of actions.

WHAT IS COMPETITIVE ADVANTAGE?

LO 1-2

Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

Competitive advantage is always *relative*, not absolute. To assess competitive advantage, we compare firm performance to a *benchmark*—that is, either the performance of other firms in the same industry or an industry average. A firm that achieves superior performance relative to other competitors in the same industry or the industry average has a **competitive advantage**.⁹ In terms of stock market valuation, Tesla has appreciated much more in recent years than GM, Ford, or Chrysler, and thus appears to have a competitive advantage, at least on this dimension.

A firm that is able to outperform its competitors or the industry average over a prolonged period has a **sustainable competitive advantage**. Apple, for example, has enjoyed a sustainable competitive advantage over Samsung in the smartphone industry for over a decade since its introduction of the iPhone in 2007. Other phone makers such as Microsoft (which purchased Nokia) and BlackBerry have all but exited the smartphone market, while new entrants such as Xiaomi and Huawei of China are trying to gain traction.

If a firm underperforms its rivals or the industry average, it has a **competitive disadvantage**. For example, a 15 percent return on invested capital may sound like

competitive advantage Superior performance relative to other competitors in the same industry or the industry average.

sustainable competitive advantage Outperforming competitors or the industry average over a prolonged period of time.

competitive disadvantage Underperformance relative to other competitors in the same industry or the industry average.

superior firm performance. In the consulting industry, though, where the average return on invested capital is often above 20 percent, such a return puts a firm at a competitive disadvantage. In contrast, if a firm's return on invested capital is 2 percent in a declining industry, like newspaper publishing, where the industry average has been negative (−5 percent) for the past few years, then the firm has a competitive advantage. Should two or more firms perform at the same level, they have **competitive parity**. In Chapter 5, we'll discuss in greater depth how to evaluate and assess competitive advantage and firm performance.

To gain a competitive advantage, a firm needs to provide either goods or services consumers value more highly than those of its competitors, or goods or services similar to the competitors' at a lower price. The rewards of superior value creation and capture are profitability and market share. Elon Musk is particularly motivated to address global warming, and thus formed Tesla to build electric vehicles with zero emissions. Sara Blakely, the founder and CEO of Spanx, the global leader in the shapewear industry, is motivated to change women's lives. Sam Walton was driven by offering lower prices than his competitors when creating Walmart, the world's largest retailer. For Musk, Blakely, Walton, and numerous other entrepreneurs and businesspeople, creating shareholder value and making money is the *consequence* of filling a need and providing a product, service, or experience consumers wanted, at a price they could afford.

The important point here is that strategy is about creating superior value, while containing the cost to create it, or by offering similar value at lower cost. Managers achieve these combinations of value and cost through *strategic positioning*. That is, they stake out a unique position within an industry that allows the firm to provide value to customers, while controlling costs. The greater the difference between value creation and cost, the greater the firm's *economic contribution* and the more likely it will gain competitive advantage.

Strategic positioning requires *trade-offs*, however. As a low-cost retailer, Walmart has a clear strategic profile and serves a specific market segment. Upscale retailer Nordstrom has also built a clear strategic profile by providing superior customer service to a higher end, luxury market segment. Although these companies are in the same industry, their customer segments overlap very little, and they are not direct competitors. Walmart and Nordstrom have each chosen a distinct but different strategic position. The managers make conscious trade-offs that enable each company to strive for competitive advantage in the retail industry, using different competitive strategies: cost leadership versus differentiation. In regard to the customer service dimension, Walmart provides acceptable service by low-skill employees in a big-box retail outlet offering “everyday low prices,” while Nordstrom provides a superior customer experience by professional salespeople in a luxury setting.

A clear strategic profile—in terms of product differentiation, cost, and customer service—allows each retailer to meet specific customer needs. Competition focuses on creating value for customers (through lower prices or better service and selection, in this example) rather than destroying rivals. Even though Walmart and Nordstrom compete in the same industry, both can win if they achieve a clear strategic position through a well-executed competitive strategy. Strategy, therefore, is not a zero-sum game.



Spanx founder and CEO Sara Blakely, a graduate of Florida State University, is the world's youngest female billionaire.

©ZUMA Press Inc/Alamy Stock Photo

competitive parity Performance of two or more firms at the same level.

The key to successful strategy is to combine a set of activities to stake out a *unique strategic position* within an industry. Competitive advantage has to come from performing different activities or performing the same activities differently than rivals are doing. Ideally, these activities reinforce one another rather than create trade-offs. For instance, Walmart's strategic activities strengthen its position as cost leader: Big retail stores in rural locations, extremely high purchasing power, sophisticated IT systems, regional distribution centers, low corporate overhead, and low base wages and salaries combined with employee profit sharing reinforce each other, to maintain the company's cost leadership.

Since clear strategic positioning requires trade-offs, strategy is as much about deciding what *not* to do, as it is about deciding what to do.¹⁰ Because resources are limited, managers must carefully consider their strategic choices in the quest for competitive advantage. Trying to be everything to everybody will likely result in inferior performance. In addition, operational effectiveness, marketing skills, and other functional expertise all strengthen a unique strategic position. Those capabilities, though, do not substitute for competitive strategy. Competing to be similar but just a bit better than your competitor is likely to be a recipe for cut-throat competition and low profit potential.

Let's take this idea to its extreme in a quick thought experiment: If all firms in the same industry pursued a low-cost position through application of competitive benchmarking, all firms would have identical cost structures. None could gain a competitive advantage. Everyone would be running faster, but nothing would change in terms of relative strategic positions. There would be little if any value creation for customers because companies would have no resources to invest in product and process improvements. Moreover, the least-efficient firms would be driven out, further reducing customer choice.

To gain a deeper understanding of what strategy is, it may be helpful to think about what strategy is *not*.¹¹ Be on the lookout for the following major hallmarks of what strategy is *not*:

1. *Grandiose statements are not strategy.* You may have heard firms say things like, "Our strategy is to win" or "We will be No. 1." Twitter, for example, declared its "ambition is to have the largest audience in the world."¹² Such statements of desire, on their own, are not strategy. They provide little managerial guidance and often lead to goal conflict and confusion. Moreover, such wishful thinking frequently fails to address economic fundamentals. As we will discuss in the next section, an effective vision and mission *can* lay the foundation upon which to craft a good strategy. This foundation must be backed up, however, by strategic actions that allow the firm to address a competitive challenge with clear consideration of economic fundamentals, in particular, value creation and costs.
2. *A failure to face a competitive challenge is not strategy.* If the firm does not define a clear competitive challenge, employees have no way of assessing whether they are making progress in addressing it. Managers at the now-defunct video rental chain Blockbuster, for example, failed to address the competitive challenges posed by new players Netflix, Redbox, Amazon Prime, and Hulu.
3. *Operational effectiveness, competitive benchmarking, or other tactical tools are not strategy.* People casually refer to a host of different policies and initiatives as some sort of strategy: pricing strategy, internet strategy, alliance strategy, operations strategy, IT strategy, brand strategy, marketing strategy, HR strategy, China strategy, and so on. All these elements may be a *necessary* part of a firm's functional and global initiatives to support its competitive strategy, but these elements are *not sufficient* to achieve competitive advantage. In this text, though, we will reserve the term *strategy* for describing the firm's overall efforts to *gain and sustain competitive advantage*.

1.2 Vision, Mission, and Values

The first step to gain and sustain a competitive advantage is to define an organization's vision, mission, and values. Managers must ask the following questions:

- **Vision.** What do we want to accomplish ultimately?
- **Mission.** How do we accomplish our goals?
- **Values.** What commitments do we make, and what guardrails do we put in place, to act both legally and ethically as we pursue our vision and mission?

The vision is the first principle that needs to be defined because it succinctly identifies the primary long-term objective of the organization. Strategic leaders need to begin with the end in mind.¹³ In fact, early on strategic success is created *twice*. Leaders create the vision in the abstract by formulating strategies that enhance the chances of gaining and sustaining competitive advantage, before any actions of strategy implementation are taken in a second round of strategy creation. This process is similar to building a house. The future owner must communicate her vision to the architect, who draws up a blueprint of the home for her review. The process is iterated a couple of times until all the homeowner's ideas have been translated into the blueprint. Only then does the building of the house begin. The same holds for strategic success; it is first created through strategy formulation based on careful analysis before any actions are taken. Let's look at this process in more detail.

VISION

A **vision** captures an organization's aspiration and spells out what it ultimately wants to accomplish. An effective vision pervades the organization with a sense of winning and motivates employees at all levels to aim for the same target, while leaving room for individual and team contributions.

Tesla's vision is *to accelerate the world's transition to sustainable transport*. The goal is to provide affordable zero-emission mass-market cars that are the best in class. SpaceX is a spacecraft manufacturer and space transport services company, also founded by Elon Musk, whose inspirational vision is *to make human life multi planetary*. To achieve this goal, SpaceX aims to make human travel to Mars not only possible but also affordable. Moreover, SpaceX also sees a role in helping establish a self-sustainable human colony on Mars.¹⁴

Employees in visionary companies tend to feel part of something bigger than themselves. An inspiring vision helps employees find meaning in their work. Beyond monetary rewards, it allows employees to experience a greater sense of purpose. People have an intrinsic motivation to make the world a better place through their work activities.¹⁵ This greater individual purpose in turn can lead to higher organizational performance.¹⁶ Basing actions on its vision, a firm will build the necessary resources and capabilities through continuous organizational learning, including learning from failure, to translate into reality what begins as a stretch goal or **strategic intent**.¹⁷

To provide meaning for employees in pursuit of the organization's ultimate goals, vision statements should be forward-looking and inspiring. Strategy Highlight 1.1 shows how Wendy Kopp, the founder of Teach for America, uses an inspiring vision to effectively and clearly communicate what TFA ultimately wants to accomplish, while providing a stretch goal.

It's not surprising that vision statements can be inspiring and motivating in the non-profit sector. Many people would find meaning in wanting to help children attain an excellent education (TFA) or wanting *to be always there*, touching the lives of people in need, the vision of the American Red Cross. But what about for-profit firms?

LO 1-3

Describe the roles of vision, mission, and values in a firm's strategy.

vision A statement about what an organization ultimately wants to accomplish; it captures the company's aspiration.

strategic intent A stretch goal that pervades the organization with a sense of winning, which it aims to achieve by building the necessary resources and capabilities through continuous learning.

Strategy Highlight 1.1

Teach for America: How Wendy Kopp Inspires Future Leaders



Wendy Kopp, Teach for America founder.
©Bloomberg/Getty Images

Teach for America (TFA) is a cadre of future leaders who work to ensure that underprivileged youth get an excellent education. The nonprofit organization recruits both graduates and professionals to teach for two years in economically disadvantaged communities in the United States. TFA's vision is: *One day, all children in this nation will have the opportunity to attain an excellent education.*

The idea behind TFA was developed by then-21-year-old Wendy Kopp as her college senior thesis (in 1989). Kopp was convinced that young people generally search for meaning in their lives by making a positive contribution to society. The genius of Kopp's idea was to turn on its head the social perception of teaching—to make what could appear to be an

unattractive, low-status job into a high-prestige professional opportunity. Kopp works to eliminate educational inequality by enlisting the nation's most promising future leaders in the effort. Thus to be chosen for TFA is a badge of honor.

In the first four months after creating TFA, Kopp received more than 2,500 applicants. Her marketing consisted of flyers in dorm rooms. During its first academic year (1990–91), TFA was able to serve five states and reached some 36,000 students. After 25 years, during the 2015–16 academic year, some 20,000 TFA corps members were teaching in 36 states (and Washington, D.C.) and more than 1,000 schools. To date, TFA has reached over 10 million students.

To see how all three components—vision, mission, and values—work together, see Exhibit 1.1, which provides a snapshot of aspirations at Teach for America.

While initially targeted at college seniors, today, one-third of all TFA corps members applied as graduate students or professionals. In 2015, TFA added 4,100 new teachers to its corps from over 27,300 applications, representing more than 800 colleges and universities throughout the United States. This equates to about 15 percent acceptance, roughly equivalent to the admission rate of highly selective universities such as Northwestern, Cornell, or University of California, Berkeley. TFA's teaching cohort is also much more diverse than the national average: While some 20 percent of teachers nationwide are people of color, about 50 percent of TFA corps members are. TFA corps members receive the same pay as other first-year teachers in the local school district.

Most importantly, TFA makes a significant positive impact on students. Some 95 percent of all school principals working with TFA members say these teachers make a positive difference. A study commissioned by the U.S. Department of Education found that students being taught by TFA corps members showed significantly higher achievement, especially in math and science.

In 2016, after celebrating its 25th anniversary, TFA CEO Elisa Villanueva Beard recalls that she was inspired to sign up for TFA (when a freshman in high school) by Wendy Kopp's "audacity to believe young people could make a profound difference in the face of intractable problems standing between the ideals of a nation I loved and a starkly disappointing reality; who were bound by a fierce belief that all children, from American Indian reservations in South Dakota to Oakland to the Rio Grande Valley to the Bronx, should have the opportunity to write their own stories and fulfill their true potential."¹⁸

EXHIBIT 1.1 / Teach for America: Vision, Mission, and Values

VISION	One day, all children in this nation will have the opportunity to attain an excellent education.
MISSION	Our mission is to enlist, develop, and mobilize as many as possible of our nation's most promising future leaders to grow and strengthen the movement for educational equity and excellence.
VALUES	Transformational Change: We seek to expand educational opportunity in ways that are life-changing for children and transforming for our country. Given our deep belief in children and communities, the magnitude of educational inequity and its consequences, and our optimism about the solvability of the problem, we act with high standards, urgency, and a long-term view. Leadership: We strive to develop and become the leaders necessary to realize educational excellence and equity. We establish bold visions and invest others in working towards them. We work in purposeful, strategic, and resourceful ways, define broadly what is within our control to solve, and learn and improve constantly. We operate with a sense of possibility, persevere in the face of challenges, ensure alignment between our actions and beliefs, and assume personal responsibility for results. Team: We value and care about each other, operate with a generosity of spirit, and have fun in the process of working together. To maximize our collective impact, we inspire, challenge, and support each other to be our best and sustain our effort. Diversity: We act on our belief that the movement to ensure educational equity will succeed only if it is diverse in every respect. In particular, we value the perspective and credibility that individuals who share the racial and economic backgrounds of the students with whom we work can bring to our organization, classrooms, and the long-term effort for change. Respect & Humility: We value the strengths, experiences, and perspectives of others, and we recognize our own limitations. We are committed to partnering effectively with families, schools, and communities to ensure that our work advances the broader good for all children.

SOURCE: www.teachforamerica.org.

Visionary companies, such as 3M, General Electric, Procter & Gamble (P&G), and Walmart, provide more aspirational ideas that are not exclusively financial. The upscale retailer Nordstrom's vision, for example, is *to provide outstanding service every day, one customer at a time*. Visionary companies often outperform their competitors over the long run. Tracking the stock market performance of companies over several decades, strategy scholars found that visionary companies outperformed their peers by a wide margin.¹⁹ A truly meaningful and inspiring vision makes employees feel they are part of something bigger. This is highly motivating and, in turn, can improve firm financial performance.

MISSION

Building on the vision, organizations establish a **mission**, which describes what an organization actually does—that is, the products and services it plans to provide, and the markets in which it will compete. People sometimes use the terms *vision* and *mission* interchangeably, but in the strategy process they differ.

- A vision defines what an organization wants to accomplish ultimately, and thus the goal can be described by the infinitive form of the verb starting with *to*. As discussed in Strategy Highlight 1.1, TFA's vision is *to attain an excellent education for all children*.
- A mission describes what an organization does; it defines *how* the vision is accomplished and is often introduced with the preposition *by*. Accordingly, we can recast

Mission Description of what an organization actually does—the products and services it plans to provide, and the markets in which it will compete.

TFA's mission that it will achieve its vision *by enlisting, developing, and mobilizing as many as possible of our nation's most promising future leaders to grow and strengthen the movement for educational equity and excellence.* (See Exhibit 1.1).

To be effective, firms need to back up their visions and missions with *strategic commitments*, in which the enterprise undertakes credible actions. Such commitments are costly, long-term oriented, and difficult to reverse.²⁰ However noble the mission statement, to achieve competitive advantage companies need to make strategic commitments informed by economic fundamentals of value creation.

As mentioned in the ChapterCase, Tesla is investing billions of dollars to equip its car factory in California with cutting-edge robotics and to build the Gigafactory producing lithium-ion batteries in Nevada. These investments by Tesla are examples of strategic commitments because they are costly, long-term, and difficult to reverse. They are clearly supporting Tesla's vision *to accelerate the world's transition to sustainable transport.* Tesla hopes to translate this vision into reality *by providing affordable zero-emission mass-market cars that are the best in class*, which captures Tesla's mission.

LO 1-4

Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

VISION STATEMENTS AND COMPETITIVE ADVANTAGE. Do vision statements help firms gain and sustain competitive advantage? It depends. The effectiveness of vision statements differs by type. *Customer-oriented* vision statements allow companies to adapt to changing environments. *Product-oriented* vision statements often constrain this ability. This is because customer-oriented vision statements focus employees to think about how best to solve a problem for a consumer.²¹

Clayton Christensen shares how a customer focus let him help a fast food chain increase sales of milk shakes. The company approached Christensen after it had made several changes to its milk-shake offering based on extensive customer feedback but sales failed to improve. Rather than asking customers what kind of milk shake they wanted, he thought of the problem in a different way. He observed customer behavior and then asked customers, "What job were you trying to do that caused you to hire that milk shake?"²² He wanted to know what problem the customers were trying to solve. Surprisingly he found that roughly half of the milk shakes were purchased in the mornings, because customers wanted an easy breakfast to eat in the car and a diversion on long commutes. Based on the insights gained from this problem-solving perspective, the company expanded its milk-shake offerings to include healthier options with fruit chunks and provided a prepaid dispensing machine to speed up the drive-through, and thus improve customers' morning commute. A customer focus made finding a solution much easier.

You could say that the restaurant company had a product orientation that prevented its executives from seeing unmet customer needs. Product-oriented vision statements focus employees on improving existing products and services without consideration of underlying customer problems to be solved. Our environments are ever-changing and sometimes seem chaotic. The increased strategic flexibility afforded by customer-oriented vision statements can provide companies with a competitive advantage.²³ Let's look at both types of vision statements in more detail.

PRODUCT-ORIENTED VISION STATEMENTS. A product-oriented vision defines a business in terms of a good or service provided. Product-oriented visions tend to force managers to take a more myopic view of the competitive landscape. Consider the strategic decisions of U.S. railroad companies. Railroads are in the business of moving goods and people from point A to point B by rail. When they started in the 1850s, their short-distance competition was the horse or horse-drawn carriage. There was little long-distance competition (e.g., ship canals or good roads) to cover the United States from coast to coast. Because of their

monopoly, especially in long-distance travel, these companies were initially extremely profitable. Not surprisingly, the early U.S. railroad companies saw their vision as being in the railroad business, clearly a product-based definition.

However, the railroad companies' monopoly did not last. Technological innovations changed the transportation industry dramatically. After the introduction of the automobile in the early 1900s and the commercial jet in the 1950s, consumers had a wider range of choices to meet their long-distance transportation needs. Rail companies were slow to respond; they failed to redefine their business in terms of services provided to the consumer. Had they envisioned themselves as serving the full range of transportation and logistics needs of people and businesses across America (a customer-oriented vision), they might have become successful forerunners of modern logistics companies such as FedEx or UPS.

Recently, the railroad companies seem to be learning some lessons: CSX Railroad is now redefining itself as a green-transportation alternative. It claims it can move one ton of freight 423 miles on one gallon of fuel. However, its vision remains product-oriented: *to be the safest, most progressive North American railroad.*

CUSTOMER-ORIENTED VISION STATEMENTS. A *customer-oriented vision* defines a business in terms of providing solutions to customer needs. For example, “We provide solutions to professional communication needs.” Companies with customer-oriented visions can more easily adapt to changing environments. Exhibit 1.2 provides additional examples of companies with customer-oriented vision statements. In contrast, companies that define themselves based on product-oriented statements (e.g., “We are in the typewriter business”) tend to be less flexible and thus more likely to fail. The lack of an inspiring needs-based vision can cause the long-range problem of failing to adapt to a changing environment.

Customer-oriented visions identify a critical need but leave open the means of how to meet that need. Customer needs may change, and the *means* of meeting those needs may change with it. The future is unknowable, and innovation is likely to provide new ways to meet needs that we cannot fathom today.²⁴ For example, consider the need to transmit information over long distances. Communication needs have persisted throughout the millennia, but the technology to solve this problem has changed drastically over time.²⁵ During the reign of Julius Caesar, moving information over long distances required papyrus, ink, a chariot, a horse, and a driver. During Abraham Lincoln's time, railroads handled this task, while an airplane was used when Franklin Delano Roosevelt was president. Today,

Alibaba: To make it easy to do business anywhere.

Amazon: To be Earth's most customer-centric company, where customers can find and discover anything they might want to buy online.

Better World Books: To harness the power of capitalism to bring literacy and opportunity to people around the world.

Facebook: To make the world more open and connected.

GE: To move, cure, build, and power the world.

Google: To organize the world's information and make it universally accessible and useful.

Nike: To bring inspiration and innovation to every athlete in the world.

SpaceX: To make human life multi planetary.

Tesla: To accelerate the world's transition to sustainable energy.

Walmart: To be the best retailer in the hearts and minds of consumers and employees.

EXHIBIT 1.2 /

Companies with
Customer-Oriented
Vision Statements

we use connected mobile devices to move information over long distances at the speed of light. The problem to be solved—moving information over long distance—has remained the same, but the technology employed to do this job has changed quite drastically. Christensen recommends that strategic leaders think hard about how the means of getting a job done have changed over time and ask themselves, “Is there an even better way to get this job done?”

It is critical that an organization’s vision should be flexible to allow for change and adaptation. Consider how Ford Motor Co. has addressed the problem of personal mobility over the past 100 years. Before Ford entered the market in the early 1900s, people traveled long distances by horse-drawn buggy, horseback, boat, or train. But Henry Ford had a different idea. In fact, he famously said, “If I had listened to my customers, I would have built a better horse and buggy.”²⁶ Instead, Henry Ford’s original vision was *to make the automobile accessible to every American*. He succeeded, and the automobile dramatically changed how mobility was achieved.

Fast-forward to today: Ford Motor Co.’s vision is *to provide personal mobility for people around the world*. Note that it does not even mention the automobile. By focusing on the consumer need for personal mobility, Ford is leaving the door open for exactly how it will fulfill that need. Today, it’s mostly with traditional cars and trucks propelled by gas-powered internal combustion engines, with some hybrid electric vehicles in its lineup. In the near future, Ford is likely to provide vehicles powered by alternative energy sources such as electric power or hydrogen. In the far-reaching future, perhaps Ford will get into the business of individual flying devices. Throughout all of this, its vision would still be relevant and compel its managers to engage in future markets. In contrast, a product-oriented vision would have greatly constrained Ford’s degree of strategic flexibility.

MOVING FROM PRODUCT-ORIENTED TO CUSTOMER-ORIENTED VISION STATEMENTS. In some cases, product-oriented vision statements do not interfere with the firm’s success in achieving superior performance and competitive advantage. Consider Intel Corp., one of the world’s leading silicon innovators. Intel’s early vision was *to be the preeminent building-block supplier of the PC industry*. Intel designed the first commercial microprocessor chip in 1971 and set the standard for microprocessors in 1978. During the personal computer (PC) revolution in the 1980s, microprocessors became Intel’s main line of business. Intel’s customers were original equipment manufacturers that produced consumer end-products, such as computer manufacturers HP, IBM, Dell, and Compaq.

In the internet age, though, the standalone PC as the end-product has become less important. Customers want to stream video and share selfies and other pictures online. These activities consume a tremendous amount of computing power. To reflect this shift, Intel in 1999 changed its vision to focus on being *the preeminent building-block supplier to the internet economy*. Although its product-oriented vision statements did not impede performance or competitive advantage, in 2008 Intel fully made the shift to a customer-oriented vision: *to delight our customers, employees, and shareholders by relentlessly delivering the platform and technology advancements that become essential to the way we work and live*. Part of this shift was reflected by the hugely successful “Intel Inside” advertising campaign in the 1990s that made Intel a household name worldwide.

Intel accomplished superior firm performance over decades through continuous adaptations to changing market realities. Its formal vision statement lagged behind the firm’s strategic transformations. Intel regularly changed its vision statement *after* it had accomplished each successful transformation.²⁷ In such a case, vision statements and firm performance are clearly not related to one another.

It is also interesting to note that customer-oriented visions also frequently change over time. When Telsa was founded in 2003, its mission was *to accelerate the world’s*

transition to sustainable transport. Over the last decade or so, Tesla completed several steps of its initial master plan (as detailed in the opening case), including providing zero-emission electric power generation options (Step 4), through the acquisition of the SolarCity. Tesla, therefore, no longer views itself as a car company but as a fully integrated clean-tech company. To capture this ambition more accurately Tesla changed its vision *to accelerate the world's transition to sustainable energy.* To reposition Tesla as an integrated clean-tech energy company, in 2017, Tesla changed its official name from Tesla Motors to Tesla, Inc.

Taken together, empirical research shows that sometimes vision statements and firm performance are *associated* with one another. A positive relationship between vision statements and firm performance is more likely to exist under certain circumstances:

- The visions are customer-oriented.
- Internal stakeholders are invested in defining the vision.
- Organizational structures such as compensation systems align with the firm's vision statement.²⁸

The upshot is that an effective vision statement can lay the foundation upon which to craft a strategy that creates competitive advantage.

VALUES

While many companies have powerful vision and mission statements, they are not enough. An organization's values also need to be clearly articulated in the strategy process. A **core values statement** matters because it provides touchstones for the employees to understand the company culture. It offers bedrock principles that employees at all levels can use to deal with complexity and to resolve conflict. Such statements can help provide the organization's employees with a moral compass.

Consider that much of unethical behavior, while repugnant, may not be illegal. Often we read the defensive comment from a company under investigation or fighting a civil suit that "we have broken no laws." However, any firm that fails to establish extra-legal, ethical standards will be more prone to behaviors that can threaten its very existence. A company whose culture is silent on moral lapses breeds further moral lapses. Over time such a culture could result in a preponderance of behaviors that cause the company to ruin its reputation, at the least, or slide into outright legal violations with resultant penalties and punishment, at the worst.

Organizational core values are the ethical standards and norms that govern the behavior of individuals within a firm or organization. Strong ethical values have two important functions. First, ethical standards and norms underlay the vision statement and provide stability to the strategy, thus laying the groundwork for long-term success. Second, once the company is pursuing its vision and mission in its quest for competitive advantage, they serve as guardrails to keep the company on track.

The values espoused by a company provide answers to the question, *how do we accomplish our goals?* They help individuals make choices that are both ethical and effective in advancing the company's goals. Strategy Highlight 1.2, featuring the pharmaceutical company Merck, provides an example of how values can drive strategic decision making, and what can happen if a company deviates from its core values.

One last point about organizational values: Without commitment and involvement from top managers, any statement of values remains merely a public relations exercise. Employees tend to follow values practiced by strategic leaders. They observe the day-to-day decisions of top managers and quickly decide whether managers are merely paying lip service to the company's stated values. Organizational core values must be lived with integrity,

LO 1-5

Justify why anchoring a firm in ethical core values is imperative for long-term success.

core values

statement Statement of principles to guide an organization as it works to achieve its vision and fulfill its mission, for both internal conduct and external interactions; it often includes explicit ethical considerations.

Organizational

core values Ethical standards and norms that govern the behavior of individuals within a firm or organization.

Strategy Highlight 1.2

Merck: Reconfirming Its Core Values

Merck's vision is to *preserve and improve human life*. The words of founder George W. Merck still form the basis of the company's values today: *We try to never forget that medicine is for the people. It is not for profits. The profits follow, and if we have remembered that, they have never failed to appear.*²⁹

ENDING RIVER BLINDNESS In 1987, Ray Vagelos, a former Merck scientist turned CEO, announced the company would donate its recently discovered drug Mectizan, without charge, to treat river blindness. For centuries, river blindness—a parasitic disease that leads to loss of eyesight—plagued remote communities in Africa and other parts of the world. Merck's executives formed a novel private-public partnership, the Mectizan Donation Program (MDP), to distribute the drug in remote areas, where health services are often not available.

After more than 25 years, more than 1 billion treatments, and some 120,000 communities served, the disease had effectively been eradicated. Merck's current CEO, Kenneth Frazier, announced himself “humbled” by the result of the company's value-driven actions.³⁰

WITHDRAWING VIOXX In the case of another drug, though, Merck's values were brought into question. Vioxx was a painkiller developed to produce fewer gastrointestinal side effects than aspirin or ibuprofen. Once the Food and Drug Administration (FDA) approved the new drug in 1999, Merck engaged in typical big pharma promotional practices:

- Heavy direct-to-consumer advertising via TV and other media.
- Luxury doctor inducements, including consulting contracts and free retreats at exotic resorts.

Merck's new drug was a blockbuster, generating revenues of \$2.5 billion a year by 2002 and growing fast.

Allegations began to appear, however, that Vioxx caused heart attacks and strokes. Critics alleged that Merck had suppressed evidence about Vioxx's dangerous side effects from



Kenneth Frazier, CEO of Merck.
©Bloomberg/Getty Images

early clinical trials. In 2004, Merck voluntarily recalled the drug. Merck's CEO at the time, Raymond Gilmartin, framed the situation in terms of knowledge learned *after* the initial release. He said he received a phone call from the head of research. “He told me that our long-term safety study of Vioxx was showing an increased risk of cardiovascular events compared to placebo, and the trial was being discontinued. . . . After analyzing the data further and consulting with outside experts, the Merck scientists recommended that we voluntarily withdraw the drug.”³¹

Regardless of what Merck knew when, the voluntary withdrawal reconfirmed in a costly way its core value that patients come before profits. Merck's reputation damaged, its stock fell almost 30 percent, eradicating \$27 billion in market value almost overnight—an amount much greater than the estimated net present value of the profits that Merck would have obtained from continued sales of Vioxx. Merck has been hit by lawsuits ever since; legal liabilities have cost the company up to \$30 billion thus far.

Some corporate social responsibility experts argue that Merck should have never put Vioxx on the market in the first place, or that it should have at least provided up front, clear assessments of the risks associated with Vioxx.³²

especially by the top management team. Unethical behavior by top managers is like a virus that spreads quickly throughout an entire organization. It is imperative that strategic leaders set an example of ethical behavior by living the core values. Strategic leaders have a strong influence in setting an organization's vision, mission, and values. This is the first step in the entire strategic management process, which is captured in the AFI strategy framework to which we turn next.

1.3 The AFI Strategy Framework

How do organizations craft and execute a strategy that enhances their chances of achieving superior performance? A successful strategy details a set of actions that managers take to gain and sustain competitive advantage. Effectively managing the strategy process is the result of three broad tasks:

1. Analyze (A)
2. Formulate (F)
3. Implement (I)

The tasks of analyze, formulate, and implement are the pillars of research and knowledge about strategic management. Although we will study each of these tasks one at a time, they are highly interdependent and frequently happen simultaneously. Effective managers do not formulate strategy without thinking about how to implement it, for instance. Likewise, while implementing strategy, managers are analyzing the need to adjust to changing circumstances.

We've captured these interdependent relationships in the **AFI strategy framework** shown in Exhibit 1.3. This framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance. In each of the three broad strategy tasks, managers focus on specific *questions*, listed below. We address these questions in specific chapters, as indicated.

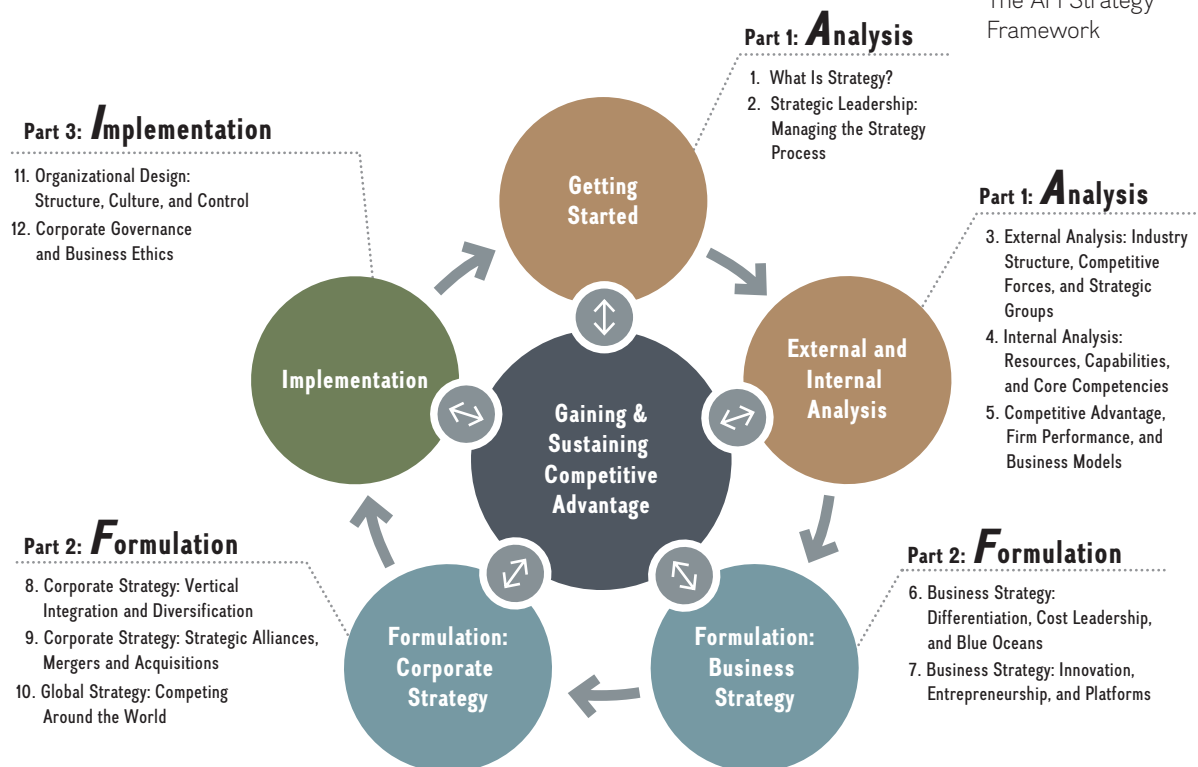
LO 1-6

Explain the AFI strategy framework.

AFI strategy framework A model that links three interdependent strategic management tasks—analyze, formulate, and implement—that, together, help managers plan and implement a strategy that can improve performance and result in competitive advantage.

EXHIBIT 1.3

The AFI Strategy Framework



Strategy Analysis (A) Topics and Questions

- Strategic leadership and the strategy process: *What roles do strategic leaders play? What is the firm's process for creating strategy and how does strategy come about? What is the relationship between stakeholder strategy and competitive advantage?* (Chapter 2)
- External analysis: *What effects do forces in the external environment have on the firm's potential to gain and sustain a competitive advantage? How should the firm deal with them?* (Chapter 3)
- Internal analysis: *What effects do internal resources, capabilities, and core competencies have on the firm's potential to gain and sustain a competitive advantage? How should the firm leverage them for competitive advantage?* (Chapter 4)
- Competitive advantage, firm performance, and business models: *How does the firm make money? How can one assess and measure competitive advantage? What is the relationship between competitive advantage and firm performance?* (Chapter 5)

Strategy Formulation (F) Topics and Questions

- Business strategy: *How should the firm compete: cost leadership, differentiation, or value innovation?* (Chapters 6 and 7)
- Corporate strategy: *Where should the firm compete: industry, markets, and geography?* (Chapters 8 and 9)
- Global strategy: *How and where should the firm compete: local, regional, national, or international?* (Chapter 10)

Strategy Implementation (I) Topics and Questions

- Organizational design: *How should the firm organize to turn the formulated strategy into action?* (Chapter 11)
- Corporate governance and business ethics: *What type of corporate governance is most effective? How does the firm anchor strategic decisions in business ethics?* (Chapter 12)

The AFI strategy framework shown in Exhibit 1.3 is repeated at the beginning of each part of this text to help contextualize where we are in our study of the firm's quest to gain and sustain competitive advantage. In addition, the *strategy process map*, presented at the end of Chapter 1, illustrates the steps in the AFI framework in more detail. The different background shades correspond to each step in the AFI framework. This strategy process map highlights the key strategy concepts and frameworks we'll cover in each chapter. It also serves as a checklist when you conduct a strategic management analysis.

We next turn to the *Implications for Strategic Leaders* section to provide practical applications and considerations of the material discussed in this chapter.

1.4 Implications for Strategic Leaders

Strategy is the art and science of success and failure. The difference between success and failure lies in an organization's strategy. A good strategy defines the competitive challenge, provides a guiding policy, and is implemented by coherent actions. Superior performance is the consequence of a good strategy. Moreover, strategic leaders appreciate the fact that competition is *everywhere*; this awareness infuses the other elements of strategy. You need a good strategy to deal with competition.

To create a powerful foundation upon which to formulate and implement a good strategy, strategic leaders need to articulate an inspiring vision and mission backed up by ethical core values. Customer-oriented or problem-defining vision statements are often correlated with firm success over long periods of time. This is because they allow firms

strategic flexibility to change in order to meet changing customer needs and exploit external opportunities. Another important implication of our discussion is that all employees should feel invested in and inspired by the firm's vision and mission. Different companies use different tactics to achieve such commitment; some firms annually invite all employees to review and revise the statement of firm values; others ask employees to rank themselves, their departments, and management on success relative to the vision and mission. Belief in a company's vision and mission motivates its employees.

The strategic leader also realizes that the principles of strategic management can be applied universally to all organizations. Strategy determines performance whether in organizations large or small, multinational Fortune 100 companies, for-profit or nonprofit organizations, in the private or the public sector, and in developed as well as emerging economies. A good strategy is more likely when strategic leaders apply the three-step AFI strategy framework:

1. Analyze the external and internal environments.
2. Formulate an appropriate business and corporate strategy.
3. Implement the formulated strategy through structure, culture, and controls.

Keep in mind that strategic leaders are making decisions under conditions of uncertainty and complexity. They must carefully monitor and evaluate the progress toward key strategic objectives and make adjustments by fine-tuning any strategy as necessary. We discuss how this is done in the next chapter where we focus on *strategic leaders* and the *strategic management process*.

This content is also relevant directly for you beyond the classroom: Applying the tools and frameworks developed in this text allows you to help your organization be more successful. You can also apply the strategic management toolkit to your own career to pursue your professional and other goals (see the *myStrategy* modules at the end of each chapter).

CHAPTERCASE 1 / Consider This . . .

In 2016, 10 years after Tesla's initial "secret strategy," Elon Musk unveiled the second part of his master plan for the company ("Master Plan, Part Deux") to continue the pursuit of its vision "to accelerate the advent of sustainable energy." Again, CEO Musk detailed a set of stretch goals:³³

1. Create stunning solar roofs with seamlessly integrated battery storage.
2. Expand the electric vehicle product line to address all major segments.
3. Develop a self-driving capability that is 10 times safer than manual via massive fleet learning.
4. Enable your car to make money for you when you aren't using it.

In the updated strategy, Step 1 leverages the integration of SolarCity. The new Tesla company is now a fully integrated sustainable energy company, combining energy generation

with energy storage from SolarCity. It provides energy generation via beautiful new solar roofs that look like regular shingles, but cost less, all things considered, and last longer.

Tesla also offers its Powerwall to residential consumers, which allows customers to store the solar energy captured on their roofs for later use. Energy generation, therefore, becomes decentralized. This implies that consumers are able to generate and use energy without being dependent on any utility, and are able to sell back excess energy to utilities. Indeed, consumers will generate not only energy for the use of their Tesla cars but also enough to cover the energy needs of the entire house.

In Step 2, Tesla is planning to expand the lineup of its electric vehicles to address all major segments, including pickup trucks, buses, and heavy-duty semis.



Tesla's new solar roof, with a Tesla car and Powerwall in the garage.
©Tesla/Newscom

In Step 3, Tesla is aiming to further develop the self-driving capabilities of its vehicles. The goal is to make self-driving vehicles 10 times safer than manual driving, and thus being able to offer fully autonomous vehicles.

Fully autonomous driving capabilities are required for Tesla to fulfill Step 4 of the new master plan: Turn your car into an income-generating asset. The idea is to offer an Uber-like service made up of Tesla vehicles, but without any drivers. On average, cars are used less than three hours during a day. The idea is that your autonomous-driving Tesla will be part of a shared vehicle fleet when you are not using your car. This will drastically reduce the total cost of ownership of a Tesla vehicle, and it will also allow pretty much anyone to ride in a Tesla as a result of the sharing economy.³⁴

Questions

1. Do you agree with the assessment that Elon Musk and Tesla successfully fulfilled their first master plan published in 2006? Why or why not? Butress your arguments.
2. As of today, does Tesla have a *good strategy*? Why or why not? How do you know?
3. Describe the rationale behind Tesla's new master plan. How does this new strategy help Tesla fulfill its vision? "Master Plan, Part Deux" in its entirety is on Tesla's blog: <https://www.tesla.com/blog/master-plan-part-deux>
4. Apply the three-step process for crafting a *good strategy* outlined in the chapter (*diagnose the competitive challenge, derive a guiding policy, and implement a set of coherent actions*) to each element of the new master plan. On which steps of the new master plan has Tesla made the most progress? Explain. Also, which recommendations would you have for Elon Musk? Support your arguments with examples and observations.

TAKE-AWAY CONCEPTS

This chapter detailed what strategy and competitive advantage is. It described the roles of vision, mission, and values in a firm's strategy. It also set the stage for further study of strategic management by introducing the AFI strategy framework, as summarized by the following learning objectives and related take-away concepts.

LO 1-1 / Explain the role of strategy in a firm's quest for competitive advantage.

- Strategy is the set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors.
- A good strategy enables a firm to achieve superior performance. It consists of three elements:
 1. A diagnosis of the competitive challenge.
 2. A guiding policy to address the competitive challenge.
 3. A set of coherent actions to implement the firm's guiding policy.
- A successful strategy requires three integrative management tasks—analysis, formulation, and implementation.

LO 1-2 / Define competitive advantage, sustainable competitive advantage, competitive disadvantage, and competitive parity.

- Competitive advantage is always judged relative to other competitors or the industry average.
- To obtain a competitive advantage, a firm must either create more value for customers while keeping its cost comparable to competitors, or it must provide the value equivalent to competitors but at a lower cost.
- A firm able to outperform competitors for prolonged periods of time has a sustained competitive advantage.
- A firm that continuously underperforms its rivals or the industry average has a competitive disadvantage.
- Two or more firms that perform at the same level have competitive parity.
- An effective strategy requires that strategic trade-offs be recognized and addressed—for example, between value creation and the costs to create the value.

LO 1-3 / Describe the roles of vision, mission, and values in a firm's strategy.

- A vision captures an organization's aspirations. An effective vision inspires and motivates members of the organization.
- A mission statement describes what an organization actually does—what its business is—and why and how it does it.
- Core values define the ethical standards and norms that should govern the behavior of individuals within the firm.

LO 1-4 / Evaluate the strategic implications of product-oriented and customer-oriented vision statements.

- Product-oriented vision statements define a business in terms of a good or service provided.
- Customer-oriented vision statements define business in terms of providing solutions to customer needs.
- Customer-oriented vision statements provide managers with more strategic flexibility than product-oriented missions.
- To be effective, visions and missions need to be backed up by hard-to-reverse

strategic commitments and tied to economic fundamentals.

LO 1-5 / Justify why anchoring a firm in ethical core values is essential for long-term success.

- Ethical core values underlay the vision statement to ensure the stability of the strategy, and thus lay the groundwork for long-term success.
- Ethical core values are the guardrails that help keep the company on track when pursuing its mission and its quest for competitive advantage.

LO 1-6 / Explain the AFI strategy framework.

- The AFI strategy framework (1) explains and predicts differences in firm performance, and (2) helps managers formulate and implement a strategy that can result in superior performance.
- Effectively managing the strategy process is the result of three broad tasks:
 1. Analyze (A)
 2. Formulate (F)
 3. Implement (I)

KEY TERMS

AFI strategy framework (p. 19)

Competitive advantage (p. 8)

Competitive disadvantage (p. 8)

Competitive parity (p. 9)

Core values statement (p. 17)

Good strategy (p. 7)

Mission (p. 13)

Organizational core values (p. 17)

Strategic intentS (p. 11)

Strategic management (p. 6)

Strategy (p. 6)

Sustainable competitive advantage (p. 8)

Vision (p. 11)

DISCUSSION QUESTIONS

1. The text discusses strategic trade-offs that are different between Walmart and Nordstrom even though they are in the same industry. Think of another industry that you know fairly well and select two firms there that also have made very different choices for these trade-offs. Describe some of the differences between these firms. What type of trade-off decisions have these firms made?
2. What characteristics does an effective mission statement have?

3. The “job to do” approach discussed with the Clayton Christensen milk-shake example can be useful in a variety of settings. Even when we are the customers ourselves sometimes we don’t look for better solutions because we get into routines and habits. Think about a situation you sometimes find frustrating in your own

life or one you hear others complaining about frequently. Instead of focusing on the annoyance, can you take a step back and look for the real job that needed doing when the frustration occurred? What other options can be developed to “do the job” that may lead to less irritation in these situations?

ETHICAL/SOCIAL ISSUES

1. In the discussion about Merck (Strategy Highlight 1.2) it is clear the firm has followed a socially responsible path by donating more than 1 billion drug treatments to remedy river blindness in remote African communities. Yet Merck must also meet shareholder responsibilities and make profits on drugs in use in more affluent societies. How should a responsible firm make these trade-offs?

What steps can strategic leaders take to guide organizations on these challenging issues?

2. The list below shows a sample of various vision/mission statements. Match the company with its corresponding statement. Also identify whether the statements are principally customer-oriented or product-oriented.

Vision/Mission Statement	Type of Statement	Matched Company	Company
To be our customers' favorite place and way to eat and drink.			1. Alibaba
To supply the consumer and our customers with the finest, high-quality products.			2. AutoNation
To help women feel great about themselves and their potential.			3. Barnes & Noble
To provide a global trading platform where practically anyone can trade practically anything.			4. CarMax
To operate the best omni-channel specialty retail business in America.			5. Darden Restaurants
To provide our customers great quality cars at great prices with exceptional customer service.			6. Dole Foods
To be financially successful through great people consistently delivering outstanding food, drinks and service in an inviting atmosphere.			7. eBay
To be America's best run, most profitable automotive retailer.			8. Estée Lauder
Bringing the best to everyone we touch and being the best in everything we do.			9. Facebook
To develop the social infrastructure to give people the power to build a global community that works for all of us.			10. KFC
To give everyone the power to create and share ideas and information instantly, without barriers.			11. Manpower
To be the best worldwide provider of higher-value staffing services and the center for quality employment opportunities.			12. McDonald's
To sell food in a fast, friendly environment that appeals to pride-conscious, health-minded consumers.			13. Spanx
To build the future infrastructure of commerce.			14. Twitter

SMALL GROUP EXERCISES

//// Small Group Exercise 1

The chapter applies the three elements of a good strategy to Tesla for insights into the company's possible competitive advantage. As a group, choose a different firm that is well known to the students. Assign the competitive challenges and company guiding policies and search the internet for information about the firm's actions. As a group discuss key actions the firm has taken and decide if they seem to be coherent. Does the firm demonstrate measures of a competitive advantage? If yes, does it look to be sustainable?

//// Small Group Exercise 2

Strategy Highlight 1.1 discusses the importance of the inspiring vision developed at Teach for America. In your group search the internet for other nonprofit organizations (Red Cross, Habitat for Humanity, etc.). Which of them has vision or mission statements that are appealing to donors, employees, and clients? Do these statements seem relevant in today's environment or are they outdated? What improvements can you create for these organizational statements?

mySTRATEGY

How Much Are Your Values Worth to You?

How much are you willing to pay for the job you want? This may sound like a strange question, since your employer will pay you to work, but think again. Consider how much you value a specific type of work, or how much you would want to work for a specific organization because of its values.

A study shows scientists who want to continue engaging in research will accept some \$14,000 less in annual salary to work at an organization that permits them to publish their findings in academic journals, implying that some scientists will "pay to be scientists." This finding appears to hold in the general business world too. In a survey, 97 percent of Stanford MBA students indicated they would forgo some 14 percent of their expected salary, or about \$11,480 a year, to work for a company that matches their own values with concern for stakeholders and sustainability. According to Monster.com, an online career service, about 92 percent of all undergraduates want to work

for a "green" company. These diverse examples demonstrate that people put a real dollar amount on pursuing careers in sync with their values.

On the other hand, certain high-powered jobs such as management consulting or investment banking pay very well, but their high salaries come with strings attached. Professionals in these jobs work very long hours, including weekends, and often take little or no vacation time. These workers "pay for pay" in that they are often unable to form stable relationships, have little or no leisure time, and sometimes even sacrifice their health. People "pay for"—make certain sacrifices for—what they value, because strategic decisions require important trade-offs.³⁵

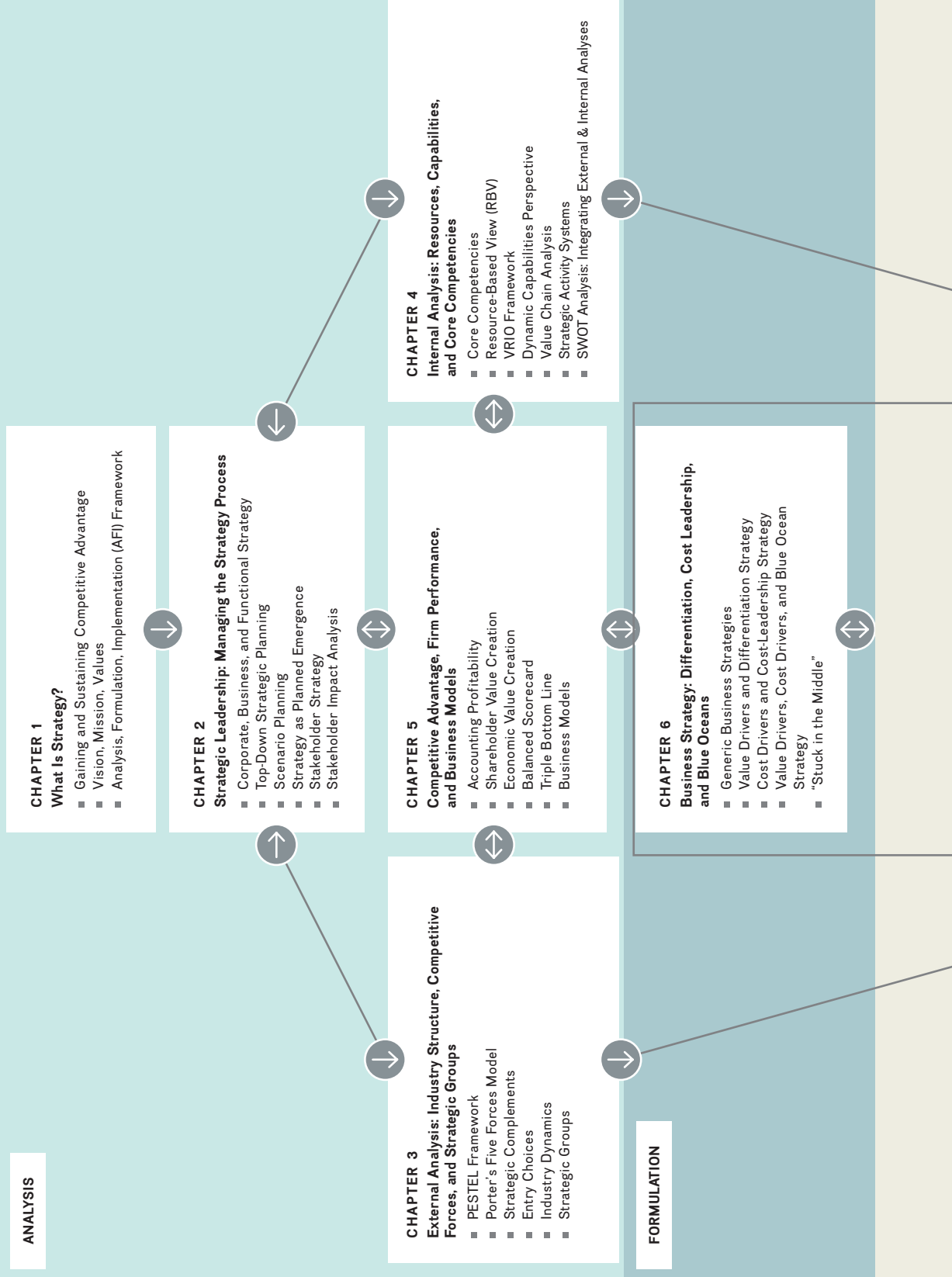
1. Identify your personal values. How do you expect these values to affect your work life or your career choice?
2. How much less salary would (did) you accept to find employment with a company that is aligned with your values?
3. How much are you willing to "pay for pay" if your dream job is in management consulting or investment banking?

ENDNOTES

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The Strategic Management Process Map !





CHAPTER 7

Business Strategy: Innovation, Entrepreneurship, and Platforms

- The 4 I's: Idea, Invention, Innovation, & Imitation
- Strategic and Social Entrepreneurship
- Innovation and the Industry Life Cycle
- Crossing the Chasm
- Technology and Markets: Types of Innovation
- Platform vs. Pipeline Business Models
- Platform Ecosystem



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- Types of Corporate Diversification
- Core Competence-Market Matrix
- BCG Growth-Share Matrix



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- Going Global: Why?, Where?, and How?
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IMPLEMENTATION

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- Matrix Structure
- Open vs. Closed Innovation
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CHAPTER 12

Corporate Governance and Business Ethics

- The Shared Value Framework
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- Agency Theory
- Board of Directors
- Other Governance Mechanisms
- Business Ethics and Sustainable Competitive Advantage



CHAPTER

2

Strategic Leadership: Managing the Strategy Process

Chapter Outline

- 2.1 Strategic Leadership**
 - What Do Strategic Leaders Do?*
 - How Do You Become a Strategic Leader?*
 - The Strategy Process across Levels: Corporate, Business, and Functional Managers*
- 2.2 The Strategic Management Process**
 - Top-Down Strategic Planning*
 - Scenario Planning*
 - Strategy as Planned Emergence: Top-Down and Bottom-Up*
- 2.3 Stakeholders and Competitive Advantage**
 - Stakeholder Strategy*
 - Stakeholder Impact Analysis*
- 2.4 Implications for Strategic Leaders**

Learning Objectives

- LO 2-1** Explain the role of strategic leaders and what they do.
- LO 2-2** Outline how you can become a strategic leader.
- LO 2-3** Describe the roles of corporate, business, and functional managers in strategy formulation and implementation.
- LO 2-4** Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence.
- LO 2-5** Assess the relationship between stakeholder strategy and sustainable competitive advantage.
- LO 2-6** Conduct a stakeholder impact analysis.

Sheryl Sandberg: Leaning in at Facebook

IN 2008, FACEBOOK was a scrappy underdog in social media. Myspace was the dominant player, and despite four years of trying, Facebook was still in second place. But Facebook CEO Mark Zuckerberg was about to make a genius move: He persuaded Sheryl Sandberg to leave Google and join Facebook as chief operating officer (COO).

As the new second in command, Sandberg brought all the business skills that Zuckerberg lacked. She had demonstrated her versatility at Google and was already renowned for her sales, business development, public policy, and communications prowess.

In contrast, Zuckerberg was more a computer hacker by heart. He liked working to build the best product to fulfill Facebook's vision to "make the world more open and connected." But he preferred coding to business deals, and freely admitted that he lacked the skill set to successfully run a business. The story of the startup got the Hollywood treatment in the film, *The Social Network*, in 2010.

Today it's only a partial simplification of their roles to say that Zuckerberg brings in the users, and Sandberg brings in the money. Their close collaboration earns deep respect within both Facebook and Silicon Valley, where many technology companies envy their synergistic leadership. To appreciate what she brought to Facebook, look what she achieved at Google.

YEARS IN THE GOOGLEPLEX

By the time she left Google, Sandberg was vice president of global online sales and operations. She had joined the company in 2001, leading a staff of 300 to develop the company's two online advertising programs, AdSense and

AdWords. Today these initiatives drive most of Google's revenues. Eric Schmidt, Google's CEO at the time, praised her as a "superstar." Under her watch, Sandberg's group had grown to 4,000 employees, or about a quarter of Google's work force.

FACEBOOK TODAY

Sandberg can claim credit for much of the success of Facebook today. As the dominant worldwide social network, it has some 2 billion monthly users. By one report, Americans spend one-third of their internet time on Facebook, most of it from mobile devices. In 2017, Facebook was the fourth most valuable company on the planet, with a market capitalization of almost \$500 billion (just behind Apple, Alphabet, and Microsoft, but ahead of Amazon).



Sheryl Sandberg, Facebook COO. ©Bloomberg/Getty Images

Facebook creates value by matching advertisers with users. Google does the same, but by different means. Google deals in objective recommendations based on its proprietary search algorithms analyzing billions of websites (e.g., "find the best sitcom on Wednesday night"). Facebook organizes its own users' data based on their social network (e.g., "find the best sitcom on Wednesday night based on what

my friends like"). Together, Google and Facebook capture more than half of all online ad spending, reaching \$140 billion in 2017.

COMPARE FACEBOOK'S EARLY YEARS

Today's social media giant was started in 2004 in a dorm room at Harvard by then 19-year-old Mark Zuckerberg and three college pals. Facebook lagged Myspace in money and users. Myspace was acquired by News Corp. for close to \$600 million in 2005, while Facebook was kept alive by cash injections from Microsoft, Yahoo, and a Russian investment group. Until 2009, Myspace was riding high with more users.

SANDBERG TODAY

As Facebook's COO, Sandberg focuses on operations, revenue, and international reach. She steps up in unexpected areas when needed, such as when she successfully completed a round of funding for Facebook after its chief financial officer had left suddenly. On numerous occasions she has mitigated Zuckerberg's public relations challenges. Many consider Sandberg the "professional face" of Facebook.

LEANING IN

Sandberg is a vocal advocate for women in leadership. Her popular TED talk, "Why We Have Too Few Women Leaders," has over 7 million views. Her 2013 book, *Lean In: Women, Work, and the Will to Lead*, shot to the bestseller list. In both, Sandberg speaks about the low number of female leaders in today's society and how to overcome this

situation. By highlighting both external as well as internal factors, Sandberg provides deep insights of why there are so few women in leadership positions. While her advice to women on dealing with internal factors is not without controversy, there is no question that her leaning in has made a difference at Facebook.

In 2012, Sandberg was appointed to the board of directors, making her the first woman to join Facebook's governing body. *Time* magazine included Sandberg in its annual list of the 100 Most Influential People, while *Forbes* magazine named her the Most Powerful Woman in Tech in its 2016 annual ranking.¹

You will learn more about Sheryl Sandberg and her leadership at Facebook by reading this chapter; related questions appear in "ChapterCase 2 / Consider This. . . ."



HOW DO STRATEGIC LEADERS like Sheryl Sandberg guide their companies to gain and sustain a competitive advantage? How do strategic leaders formulate and implement their companies' strategies? How do they lead and motivate employees? In Chapter 2, we move from thinking about why strategy is important to considering the role strategic leaders play. We look at how strategic leaders guide and manage the strategy process across different levels in the organization. We explore some of the frameworks they use to develop strategy. We also move beyond an understanding of competitive advantage solely as superior firm financial performance, and introduce the framework of stakeholder strategy. This allows us to appreciate the role of business in society more broadly. And finally, we summarize some of the most important practical insights in our *Implications for Strategic Leaders*.

LO 2-1

Explain the role of strategic leaders and what they do.

strategic leadership

Executives' use of power and influence to direct the activities of others when pursuing an organization's goals.

2.1 Strategic Leadership

Executives whose vision and decisions enable their organizations to achieve competitive advantage demonstrate strategic leadership.² **Strategic leadership** pertains to executives' use of power and influence to direct the activities of others when pursuing an organization's goals.³ *Power* is defined as the strategic leader's ability to influence the behavior of other organizational members to do things, including things they would not do otherwise.⁴ Strategic leaders can draw on position power as vested in their authority, for example as chief executive officer (CEO), as well as informal power, such as persuasion to influence others when implementing strategy.

In leading Facebook to become the most successful social network and one of the most valuable companies worldwide, Sheryl Sandberg has clearly demonstrated effective strategic leadership. As chief operating officer, Sandberg has tremendous position power because she is the second in command at Facebook and reports only to CEO Mark Zuckerberg. Sandberg's business development skills are legend: She transformed a money-losing outfit into a titan of online advertising, with some \$30 billion in annual revenues. She designed and implemented Facebook's business model (how it makes money). In particular, Sandberg has attracted high-profile advertisers by demonstrating how Facebook can place

precisely targeted and timed ads when it matches what it knows about each user, based on that person's social networks, with the advertisers' targets. Less quantifiable, but perhaps an even more valuable contribution, Sandberg provides "adult supervision and a professional face" for a firm populated by socially awkward computer geeks.⁵

While the effect of strategic leaders may vary, they clearly matter to firm performance.⁶ Think of great business founders and their impact on the companies they built—Mark Zuckerberg at Facebook, Elon Musk at Tesla and SpaceX, Jack Ma at Alibaba, Oprah Winfrey with her media empire, and Jeff Bezos at Amazon. There are also many strategic leaders who have shaped and revitalized existing businesses: Sheryl Sandberg at Facebook, Angela Ahrendts at Apple (former CEO of Burberry, a luxury fashion house), Mary Barra at GM, Indra Nooyi at PepsiCo, Howard Schultz at Starbucks, and Satya Nadella at Microsoft.⁷

At the other end of the spectrum, some CEOs have massively destroyed shareholder value: Ken Lay at Enron, John Sculley at Apple, Bernard Ebbers at WorldCom, Charles Prince at Citigroup, Richard Fuld at Lehman Brothers, Richard Wagoner at GM, Robert Nardelli at The Home Depot and later Chrysler, Martin Winterkorn at VW, and Ron Johnson at JCPenney, among many others.

Why do some leaders create great companies or manage them to greatness, while others lead them into decline and sometimes even demise? To answer that question, let's first consider what strategic leaders actually do.



Indra Nooyi, PepsiCo CEO.
©Bloomberg/Getty Images

WHAT DO STRATEGIC LEADERS DO?

What do strategic leaders do that makes some more effective than others? In a study of more than 350 CEOs, strategy scholars found that they spend, on average, 67 percent of their time in meetings, 13 percent working alone, 7 percent on e-mail, 6 percent on phone calls, 5 percent on business meals, and 2 percent on public events such as ribbon-cutting for a new factory (see Exhibit 2.1).⁸ Other studies have also found that most managers prefer oral communication: CEOs spend most of their time "interacting—talking, cajoling, soothing, selling, listening, and nodding—with a wide array of parties inside and outside the organization."⁹ Surprisingly given the advances in information technology, CEOs today spend most of their time in face-to-face meetings. They consider face-to-face meetings most effective in getting their message across and obtaining the information they need. Not only do meetings present data through presentations and verbal communications, but they also enable CEOs to pick up on rich nonverbal cues such as facial expressions, body language, and mood, that are not apparent to them if they use e-mail or Skype, for example.¹⁰

upper-echelons theory

A conceptual framework that views organizational outcomes—strategic choices and performance levels—as reflections of the values of the members of the top management team.

HOW DO YOU BECOME A STRATEGIC LEADER?

Is becoming an ethical and effective strategic leader innate? Can it be learned? According to the **upper-echelons theory**, organizational outcomes including strategic choices and performance levels reflect the values of the top management team.¹¹ These are the individuals at the upper levels of an organization. The theory states that strategic leaders interpret

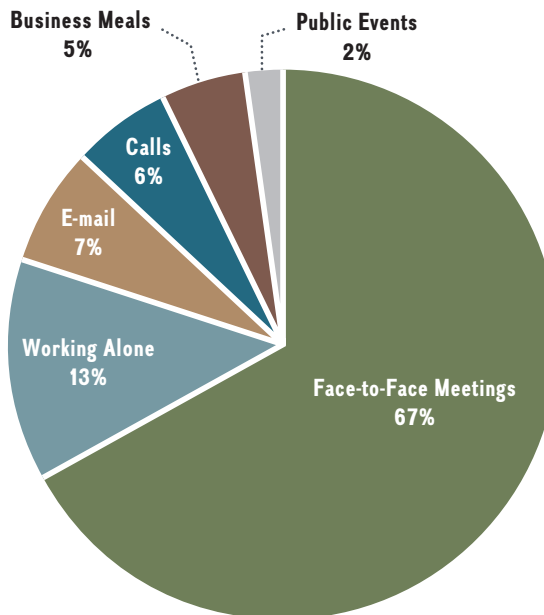
LO 2-2

Outline how you can become a strategic leader.

EXHIBIT 2.1 /

How CEOs Spend Their Days

SOURCE: Data from O. Bandiera, A. Prat, and R. Sadun (2012), "Management capital at the top: Evidence from the time use of CEOs," *London School of Economics and Harvard Business School Working Paper*.



situations through the lens of their unique perspectives, shaped by personal circumstances, values, and experiences. Their leadership actions reflect characteristics of age, education, and career experiences, filtered through personal interpretations of the situations they face. The upper-echelons theory favors the idea that effective strategic leadership is the result of both innate abilities *and* learning.

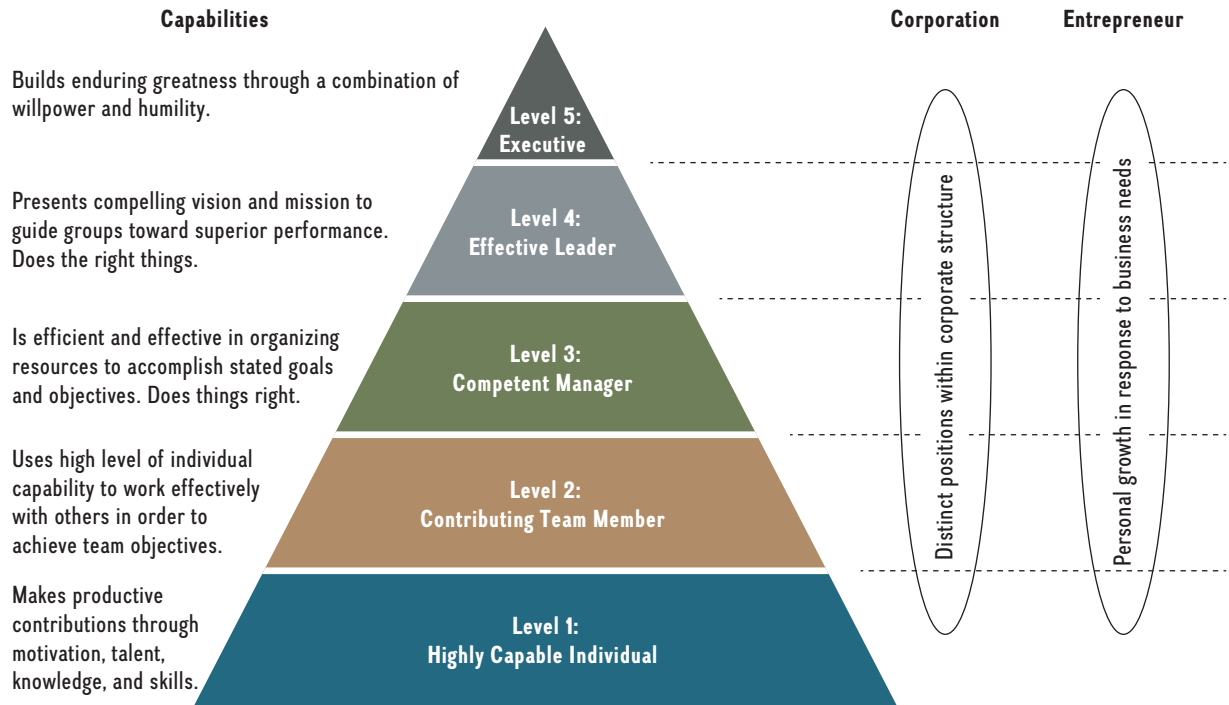
In the bestseller *Good to Great*, Jim Collins explored over 1,000 *good* companies to find 11 *great* ones. He identified *great companies* as those that transitioned from average performance to sustained competitive advantage. He measured that transition as “cumulative stock returns of almost seven times the general market in the 15 years following their transition points.”¹² A lot has happened since the book was published over a decade ago. Today only a few of the original 11 stayed all that great, including Kimberly-Clark and Walgreens. Some fell back to mediocrity; a few no longer exist in their earlier form or at all. Anyone remember Circuit City or Fannie Mae? Let’s agree that competitive advantage is hard to achieve and even harder to sustain. But his study remains valuable for its thought-provoking observations. Studying these large corporations, Collins found consistent patterns of leadership among the top companies, as pictured in the **Level-5 leadership pyramid** in Exhibit 2.2.¹³ The pyramid is a conceptual framework that shows leadership progression through five distinct, sequential levels. Collins found that all the companies he identified as *great* were led by Level-5 executives. So if you are interested in becoming an ethical and effective strategic leader, the leadership pyramid suggests the areas of growth required.

According to the Level-5 leadership pyramid, effective strategic leaders go through a natural progression of five levels. Each level builds upon the previous one; the individual can move on to the next level of leadership only when the current level has been mastered. On the left (in Exhibit 2.2) are the capabilities associated with each level. But not all companies are Fortune 500 behemoths. On the right we suggest that the model is valuable as well to the individual looking to develop the capacity for greater professional success.

Level-5 leadership pyramid A conceptual framework of leadership progression with five distinct, sequential levels.

EXHIBIT 2.2 / Strategic Leaders: The Level-5 Pyramid

Adapted to compare corporations and entrepreneurs



SOURCE: Adapted from Collins, J. (2001). *Good to Great: Why Some Companies Make the Leap . . . And Others Don't* (New York: HarperCollins), 20.

At Level 1, we find the highly capable individual who makes productive contributions through her motivation, talent, knowledge, and skills. These traits are a necessary but not sufficient condition to move on to Level 2, where the individual attains the next level of strategic leadership by becoming an effective team player. As a contributing team member, she works effectively with others to achieve common objectives. In Level 3, the team player with a high individual skill set turns into an effective manager who is able to organize the resources necessary to accomplish the organization's goals. Once these three levels are mastered, in Level 4, the effective professional has learned to do the right things, meaning she does not only command a high individual skill set and is an effective team player and manager, but she also knows what actions are the right ones in any given situation to pursue an organization's strategy. Combining all four prior levels, at Level 5, the strategic leader builds enduring greatness by combining willpower and humility. This implies that a Level-5 executive works to help the organization succeed and others to reach their full potential.

As detailed in the ChapterCase, Facebook CEO Mark Zuckerberg highly values Sheryl Sandberg, the COO. Here he says why: "She could go be the CEO of any company that she wanted, but I think the fact that she really wants to get her hands dirty and work, and doesn't need to be the front person all the time, is the amazing thing about her. It's that low-ego element, where you can help the people around you and not need to be the face of all the stuff."¹⁴ Clearly, Sandberg is a Level-5 executive: She builds enduring greatness at Facebook through a combination of skill, willpower, and humility.

LO 2-3

Describe the roles of corporate, business, and functional managers in strategy formulation and implementation.

strategy formulation

The part of the strategic management process that concerns the choice of strategy in terms of where and how to compete.

strategy implementation

The part of the strategic management process that concerns the organization, coordination, and integration of how work gets done, or strategy execution.

THE STRATEGY PROCESS ACROSS LEVELS: CORPORATE, BUSINESS, AND FUNCTIONAL MANAGERS

According to the upper-echelons theory, strategic leaders primarily determine a firm's ability to gain and sustain a competitive advantage through the strategies they pursue. Given the importance of such strategies, we need to gain a deeper understanding of how they are created. The *strategy process* consists of two parts: *strategy formulation* (which results from strategy analysis) and *strategy implementation*.

Strategy formulation concerns the choice of strategy in terms of *where and how to compete*. In contrast, **strategy implementation** concerns the organization, coordination, and integration of *how work gets done*. In short, it concerns the *execution of strategy*. It is helpful to break down strategy formulation and implementation into three distinct areas—corporate, business, and functional.

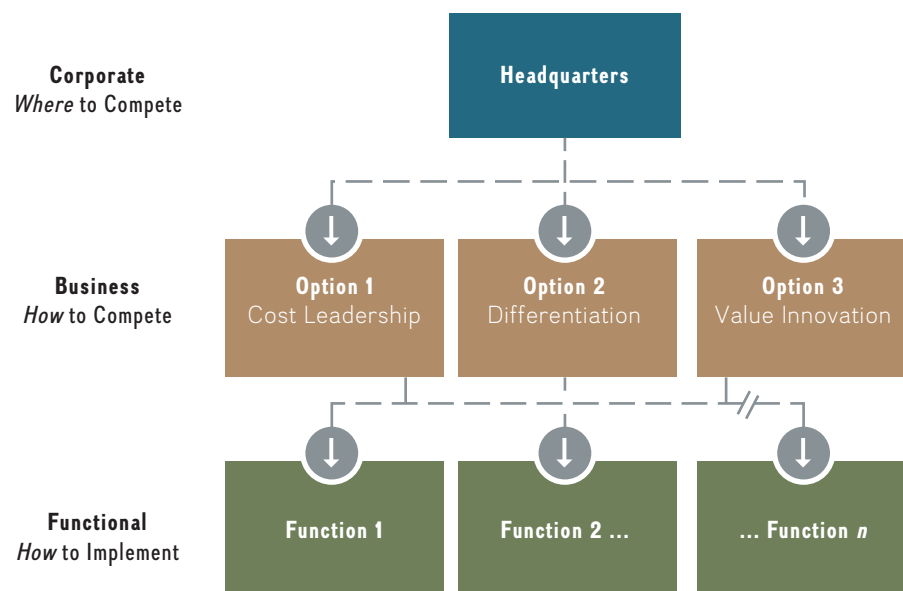
- *Corporate strategy* concerns questions relating to where to compete as to industry, markets, and geography.
- *Business strategy* concerns the question of how to compete. Three generic business strategies are available: cost leadership, differentiation, or value innovation.
- *Functional strategy* concerns the question of how to implement a chosen business strategy. Different corporate and business strategies will require different activities across the various functions.

Exhibit 2.3 shows the three areas of strategy formulation and implementation.

Although we generally speak of the firm in an abstract form, individual employees make strategic decisions—whether at the corporate, business, or functional level. *Corporate executives* at headquarters formulate corporate strategy. Think of corporate executives including Sheryl Sandberg (Facebook), John Flannery (GE), Virginia Rometty (IBM), Mukesh Ambani (Reliance Industries), Mary Barra (GM), or Marillyn Hewson (Lockheed Martin). Corporate executives need to decide in which industries, markets, and geographies their companies should compete. They need to formulate a strategy

EXHIBIT 2.3 /

Strategic Formulation and Implementation across Levels: Corporate, Business, and Functional Strategy



that can create synergies across business units that may be quite different, and determine the boundaries of the firm by deciding whether to enter certain industries and markets and whether to sell certain divisions. They are responsible for setting overarching strategic objectives and allocating scarce resources among different business divisions, monitoring performance, and making adjustments to the overall portfolio of businesses as needed. The objective of corporate-level strategy is to increase overall corporate value so that it is higher than the sum of the individual business units.

Business strategy occurs within **strategic business units (SBUs)**, the standalone divisions of a larger conglomerate, each with its own profit-and-loss responsibility. General managers in SBUs must answer business strategy questions relating to how to compete in order to achieve superior performance. Within the guidelines received from corporate headquarters, they formulate an appropriate generic business strategy, including cost leadership, differentiation, or value innovation, in their quest for competitive advantage.

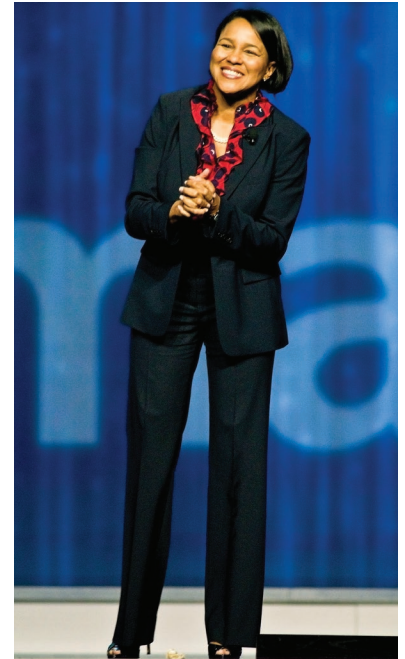
Rosalind Brewer, (former) president and CEO of Sam's Club, pursued a somewhat different business strategy from the strategy of parent company Walmart. By offering higher-quality products and brand names with bulk offerings and by prescreening customers via required Sam's Club memberships to establish creditworthiness, Brewer achieved annual revenues of roughly \$60 billion. This would place Sam's Club in the top 50 in the Fortune 500 list. Although as CEO of Sam's Club, Brewer was responsible for the performance of this strategic business unit, she reported to Walmart's CEO, Doug McMillon, who as corporate executive oversees Walmart's entire operations, with close to \$500 billion in annual revenues and over 11,000 stores globally.¹⁵

Within each strategic business unit are various business *functions*: accounting, finance, human resources, product development, operations, manufacturing, marketing, and customer service. Each *functional manager* is responsible for decisions and actions within a single functional area. These decisions aid in the implementation of the business-level strategy, made at the level above (see Exhibit 2.3).

Returning to our ChapterCase, COO Sheryl Sandberg determines Facebook's corporate strategy jointly with CEO Mark Zuckerberg. Facebook, with some 15,000 employees, is a far-flung internet firm with its various services available in more than 90 languages, and with offices in more than 30 countries.¹⁶ Together, they are responsible for the performance of the entire organization, and decide:

- What types of products and services to offer.
- Which industries to compete in.
- Where in the world to compete.

One example of Sandberg's effective strategic leadership is Facebook's turnaround beginning in 2013 when it did not have much of a mobile presence. Part of the problem was the inferior quality of the mobile app; Zuckerberg had initially built Facebook for the desktop personal computer, not for mobile devices. Sandberg initiated a company-wide "mobile first" initiative focusing its engineers and marketers on mobile. The success of this turnaround strategy is stunning: Today Facebook is a mobile advertising powerhouse, generating over 80 percent of its revenues (\$30 billion annually) from mobile advertising.¹⁷



Rosalind Brewer, Sam's Club president and CEO (2012–2017).

©AP Images/April L Brown

strategic business units (SBUs)
Standalone divisions of a larger conglomerate, each with their own profit-and-loss responsibility.

LO 2-4

Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence.

strategic management process Method put in place by strategic leaders to formulate and implement a strategy, which can lay the foundation for a sustainable competitive advantage.

top-down strategic planning A rational, data-driven strategy process through which top management attempts to program future success.

2.2 The Strategic Management Process

An effective **strategic management process** lays the foundation for sustainable competitive advantage. Strategic leaders design a process to formulate and implement strategy. In the prior section, we gained insight into the corporate, business, and functional levels of strategy. Here we turn to the process or method by which strategic leaders formulate and implement strategy. When setting the strategy process, strategic leaders rely on three approaches:

1. Strategic planning.
2. Scenario planning.
3. Strategy as planned emergence.

This order also reflects how these approaches were developed: strategic planning, then scenario planning, and then strategy as planned emergence. The first two are relatively formal, top-down planning approaches. The third approach begins with a strategic plan but offers a less formal and less stylized approach. Each approach has its strengths and weaknesses, depending on the circumstances under which it is employed.

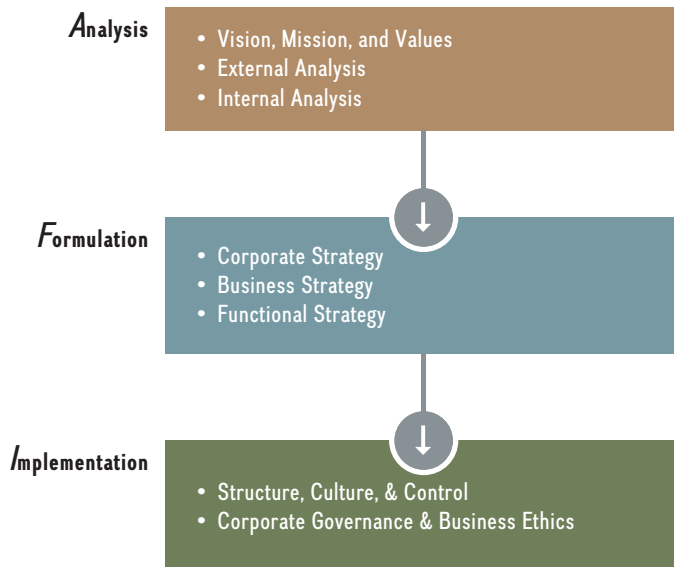
TOP-DOWN STRATEGIC PLANNING

The prosperous decades after World War II resulted in tremendous growth of corporations. As company executives needed a way to manage ever more complex firms more effectively, they began to use strategic planning.¹⁸ **Top-down strategic planning**, derived from military strategy, is a rational process through which executives attempt to program future success.¹⁹ In this approach, all strategic intelligence and decision-making responsibilities are concentrated in the office of the CEO. The CEO, much like a military general, leads the company strategically through competitive battles.

Exhibit 2.4 shows the three steps of analysis, formulation, and implementation in a traditional top-down strategic planning process. Strategic planners provide detailed analyses of internal and external data and apply it to all quantifiable areas: prices, costs, margins, market demand, head count, and production runs. Five-year plans, revisited regularly, predict future sales based on anticipated growth. Top executives tie the allocation of the annual corporate budget to the strategic plan and monitor ongoing performance accordingly. Based on a careful analysis of these data, top managers reconfirm or adjust the company's vision, mission, and values before formulating corporate, business, and functional strategies. Appropriate organizational structures and controls as well as governance mechanisms aid in effective implementation.

Top-down strategic planning more often rests on the assumption that we can predict the future from the past. The approach works reasonably well when the environment does not change much. One major shortcoming of the top-down strategic planning approach is that the formulation of strategy is separate from implementation, and thinking about strategy is separate

EXHIBIT 2.4 / Top-Down Strategic Planning in the AFI Framework



from doing it. Information flows one way only: from the top down. Another shortcoming of the strategic planning approach is that we simply cannot know the future. There is no data. Unforeseen events can make even the most scientifically developed and formalized plans obsolete. Moreover, strategic leaders' visions of the future can be downright wrong, a few notable exceptions to the contrary.

At times, strategic leaders impose their visions onto a company's strategy, structure, and culture from the top down to create and enact a desired future state. Under its co-founder and longtime CEO Steve Jobs, Apple was one of the few successful tech companies using a top-down strategic planning process.²⁰ Jobs felt that he knew best what the next big thing should be. Under his top-down, autocratic leadership, Apple did not engage in market research, because Jobs firmly believed that "people don't know what they want until you show it to them."²¹ Based on an in-depth study resulting in his 700-page *Steve Jobs* biography, Walter Isaacson distills Jobs' 14 lessons in strategic leadership, including: push for perfection, tolerate only "A" players, bend reality, among others.²²

The traditional top-down strategy process served Apple well as it became the world's most valuable company. Apple's strategy process has become more flexible under Tim Cook, Jobs' successor as CEO, and the company is trying to incorporate the possibilities of different future scenarios and bottom-up strategic initiatives.²³

SCENARIO PLANNING

Given that the only constant is change, should managers even try to strategically plan for the future? The answer is yes—but they also need to expect that unpredictable events will happen. Strategic planning in a fast-changing environment happens in a similar fashion to the planning in a fire department.²⁴ There is no way to know where and when the next emergency will arise, nor can we know its magnitude beforehand. Nonetheless, fire chiefs put contingency plans in place to address a wide range of emergencies along different dimensions.

In the same way, **scenario planning** asks those "what if" questions. Similar to top-down strategic planning, scenario planning also starts with a top-down approach to the strategy process. In addition, in scenario planning, top management envisions different scenarios, to anticipate plausible futures in order to derive strategic responses. For example, new laws might restrict carbon emissions or expand employee health care. Demographic shifts may alter the ethnic diversity of a nation; changing tastes or economic conditions will affect consumer behavior. Technological advance may provide completely new products, processes, and services. How would any of these changes affect a firm, and how should it respond? Scenario planning takes place at both the corporate and business levels of strategy.

scenario planning Strategy planning activity in which top management envisions different what-if scenarios to anticipate plausible futures in order to derive strategic responses.

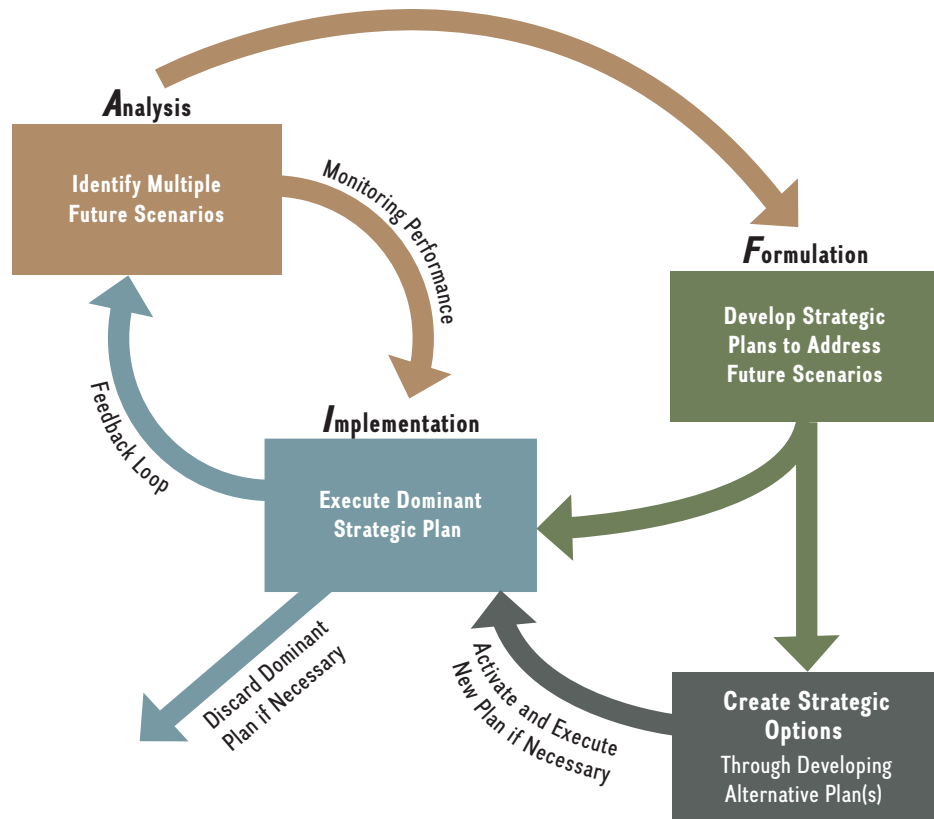
Typical scenario planning addresses both optimistic and pessimistic futures. For instance, strategy executives at UPS identified a number of issues as critical to shaping its future competitive scenarios: (1) big data analytics; (2) being the target of a terrorist attack, or having a security breach or IT system disruption; (3) large swings in energy prices, including gasoline, diesel and jet fuel, and interruptions in supplies of these commodities; (4) fluctuations in exchange rates or interest rates; and (5) climate change.²⁵ Managers then formulate strategic plans they could activate and implement should the envisioned optimistic or pessimistic scenarios begin to appear.

To model the scenario-planning approach, place the elements in the AFI strategy framework in a continuous feedback loop, where analysis leads to formulation to implementation and back to analysis. Exhibit 2.5 elaborates on this simple feedback loop to show the dynamic and iterative method of scenario planning.

The goal is to create a number of detailed and executable strategic plans. This allows the strategic management process to be more flexible and more effective than the more static

EXHIBIT 2.5 /

Scenario Planning
within the AFI
Strategy Framework



strategic planning approach with one master plan. In the *analysis stage*, managers brainstorm to identify possible future scenarios. Input from several different levels within the organization and from different functional areas such as R&D, manufacturing, and marketing and sales is critical. UPS executives considered, for example, how they would compete if the price of a barrel of oil was \$35, or \$100, or even \$200. Managers may also attach probabilities (highly likely versus unlikely, or 85 percent likely versus 2 percent likely) to different future states.

Although managers often tend to overlook pessimistic future scenarios, it is imperative to consider negative scenarios carefully. Exporters such as Boeing, Harley-Davidson, or John Deere would want to analyze the impact of shifts in exchange rates on profit margins. They might go through an exercise to derive different strategic plans based on large exchange rate fluctuations of the U.S. dollar against major foreign currencies such as the euro, Japanese yen, or Chinese yuan. What if the euro depreciated to below \$1 per euro, or the Chinese yuan depreciated rather than appreciated? How would Disney compete if the dollar were to appreciate so much as to make visits by foreign tourists to its California and Florida theme parks prohibitively expensive?

Strategic leaders need also consider how **black swan events** might affect their strategic planning. In the past, most people assumed that all swans are white, so when they first encountered swans that were black, they were surprised.²⁶ Examples of black swan events include the 9/11 terrorist attacks, the British exit from the European Union (Brexit), and the European refugee and migrant crisis. The BP oil spill was a black swan for many businesses on the Gulf Coast, including the tourism, fishing, and energy industries. We discuss the BP Deepwater Horizon explosion and its consequences in much more detail in Strategy Highlight 2.2, in the next section. Such black swan events were considered to be highly

black swan events Incidents that describe highly improbable but high-impact events.

improbable and thus unexpected, but when they did occur, each had a very profound impact.

The metaphor of a black swan, therefore, describes the *high impact of a highly improbable event*. In the UPS scenario planning exercise, a terrorist attack or a complete security breach of its IT system are examples of possible black swan events. Looking at highly improbable but high-impact events allows UPS executives to be less surprised and more prepared should they indeed occur.

In the *formulation stage* in scenario planning, management teams develop different strategic plans to address possible future scenarios. This kind of what-if exercise forces managers to develop detailed contingency plans before events occur. Each plan relies on an entire set of analytical tools, which we will introduce in upcoming chapters. They capture the firm's internal and external environments when answering several key questions:

- What resources and capabilities do we need to compete successfully in each future scenario?
- What strategic initiatives should we put in place to respond to each respective scenario?
- How can we shape our expected future environment?

By formulating responses to the varying scenarios, managers build a portfolio of future options. They then continue to integrate additional information over time, which in turn influences future decisions. Finally, managers transform the most viable options into full-fledged, detailed strategic plans that can be activated and executed as needed. The scenarios and planned responses promote strategic flexibility for the organization. If a new scenario should emerge, the company won't lose any time coming up with a new strategic plan. It can activate a better suited plan quickly based on careful scenario analysis done earlier.

In the *implementation stage*, managers execute the **dominant strategic plan**, the option that top managers decide most closely matches the current reality. If the situation changes, managers can quickly retrieve and implement any of the alternate plans developed in the formulation stage. The firm's subsequent performance in the marketplace gives managers real-time feedback about the effectiveness of the dominant strategic plan. If performance feedback is positive, managers continue to pursue the dominant strategic plan, fine-tuning it in the process. If performance feedback is negative, or if reality changes, managers consider whether to modify further the dominant strategic plan in order to enhance firm performance or to activate an alternative strategic plan.

The circular nature of the scenario-planning model in Exhibit 2.5 highlights the continuous interaction among analysis, formulation, and implementation. Through this interactive process, managers can adjust and modify their actions as new realities emerge. The interdependence among analysis, formulation, and implementation also enhances organizational learning and flexibility.



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dominant strategic plan The strategic option that top managers decide most closely matches the current reality and which is then executed.

STRATEGY AS PLANNED EMERGENCE: TOP-DOWN AND BOTTOM-UP

Critics of top-down and scenario planning argue that *strategic planning* is not the same as *strategic thinking*.²⁷

In fact, they argue the strategic planning processes are often too regimented and confining. As such, they lack the flexibility needed for quick and effective response. Managers

illusion of control A tendency by people to overestimate their ability to control events.

engaged in a more formalized approach to the strategy process may also fall prey to an **illusion of control**, which describes a tendency by managers to overestimate their ability to control events.²⁸ Hard numbers in a strategic plan can convey a false sense of security. According to critics of strategic planning, to be successful, a strategy should be based on an inspiring vision and not on hard data alone. They advise that strategic leaders should focus on all types of information sources, including soft sources that can generate new insights, such as personal experience, deep domain expertise, or the insights of front-line employees. The important work, according to this viewpoint, is to synthesize all available input from different internal and external sources into an overall strategic vision. An inspiring vision in turn should then guide the firm's strategy (as discussed in Chapter 1).

In today's complex and uncertain world, the future cannot be predicted from the past with any degree of certainty. Black swan events can profoundly disrupt businesses and society. Moreover, the other two approaches to planning just discussed do not account sufficiently for the role employees at all levels of the organization may play. This is because lower-level employees not only implement the given strategy, but they also frequently come up with initiatives on their own that may alter a firm's strategy. In many instances, front-line employees have unique insights based on constant and unfiltered customer feedback that may elude the more removed executives. Moreover, hugely successful strategic initiatives are occasionally the result of *serendipity*, or unexpected but pleasant surprises.

In 1990, for example, online retailing was nonexistent. Today, almost all internet users have purchased goods and services online. As a total of all sales, online retailing was about 20 percent in 2017 and expected to double by 2026.²⁹ Given the success of Amazon as the world's leading online retailer, brick-and-mortar companies such as Best Buy, The Home Depot, JCPenney, Sears, and even Walmart have all been forced to respond and adjust their strategy. Others such as Kmart or Radio Shack filed for Chapter 11 bankruptcy (and later reorganized), while Circuit City, Borders, and others, went out of business altogether. Given the more or less instant global presence of online retailers,³⁰ Alibaba is emerging as the leading internet-based wholesaler connecting manufacturers in China to retailers in the West, as well as a direct online retailer. In a similar fashion, Uber and Lyft, the app-based ride-hailing services, are disrupting the existing taxi and limousine businesses in many metropolitan areas around the world. Having been protected by decades of regulations, existing taxi and limo services scramble to deal with the unforeseen competition. Many try through the courts or legislative system to block Uber and Lyft, alleging the ride-sharing services violate safety and other regulations. Another *sharing economy* new venture, Airbnb, an online platform that allows users to list or rent lodging of residential properties, is facing a similar situation.

The critics of more formalized approaches to strategic planning, most notably Henry Mintzberg, propose a third approach to the strategic management process. In contrast to the two top-down strategy processes discussed above, this one is a less formal and less stylized approach to the development of strategy. To reflect the reality that strategy can be planned *or* emerge from the bottom up, Exhibit 2.6 shows a more integrative approach to managing the strategy process. Please note that even in strategy as planned emergence, the overall strategy process still unfolds along the AFI framework of analysis, formulation, and implementation.

According to this more holistic model, the strategy process also begins with a top-down strategic plan based on analysis of external and internal environments. This analysis completes the first stage of the AFI framework (see Exhibit 2.6). Top-level executives then design an **intended strategy**—the outcome of a rational and structured, top-down strategic plan. Exhibit 2.6 illustrates how parts of a firm's *intended strategy* are likely to fall by the wayside because of unpredictable events and turn into *unrealized strategy*.

intended strategy The outcome of a rational and structured top-down strategic plan.

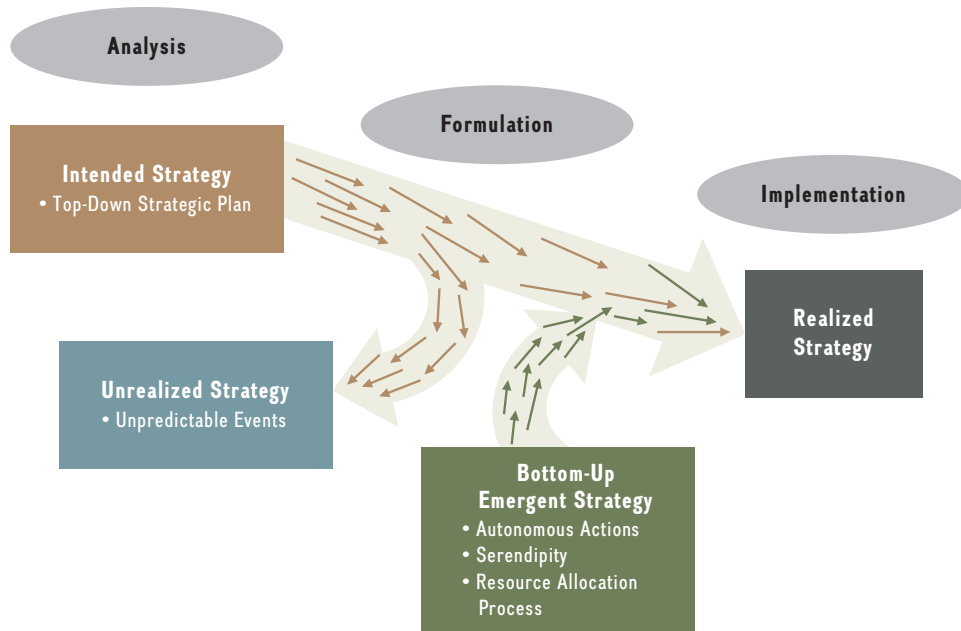


EXHIBIT 2.6 /
Realized Strategy
Is a Combination of
Top-Down Intended
Strategy and
Bottom-Up Emergent
Strategy

A firm's **realized strategy** is generally formulated through a combination of its top-down strategic intentions and bottom-up emergent strategy. An **emergent strategy** describes any unplanned strategic initiative bubbling up from deep within the organization. If successful, emergent strategies have the potential to influence and shape a firm's overall strategy.

The strategic initiative is a key feature in the strategy as a planned emergence model. A **strategic initiative** is any activity a firm pursues to explore and develop new products and processes, new markets, or new ventures. Strategic initiatives can come from anywhere. They could emerge as a response to external trends or come from internal sources. As such, strategic initiatives can be the result of top-down planning by executives, or they can also emerge through a *bottom-up process*. Many high-tech companies employ the planned emergence approach to formulate strategy. For example, the delivery-by-drone project at Amazon.com was conceived of and invented by a low-level engineer. Even relatively junior employees can come up with strategic initiatives that can make major contributions if the strategy process is sufficiently open and flexible.³¹

The arrows in Exhibit 2.6 represent different strategic initiatives. In particular, strategic initiatives can bubble up from deep within a firm through:

- Autonomous actions.
- Serendipity.
- Resource-allocation process (RAP).³²

AUTONOMOUS ACTIONS. **Autonomous actions** are strategic initiatives undertaken by lower-level employees on their own volition and often in response to unexpected situations. Strategy Highlight 2.1 illustrates that successful emergent strategies are sometimes the result of *autonomous actions* by lower-level employees.



Amazon Prime Air is a future service that will deliver packages up to five pounds in 30 minutes or less using small drones.

©Amazon/Zuma Press/Newscom

realized strategy
Combination of intended
and emergent strategy.

emergent strategy Any
unplanned strategic
initiative bubbling up
from the bottom of the
organization.

Strategy Highlight 2.1

Starbucks CEO: “It’s Not What We Do”

Diana, a Starbucks store manager in Southern California, received several requests a day for an iced beverage offered by a local competitor. After receiving more than 30 requests one day, she tried the beverage herself. Thinking it might be a good idea for Starbucks to offer a similar iced beverage, she requested that headquarters consider adding it to the product lineup. Diana had an internal champion in Howard Behar, then a top Starbucks executive. Behar presented this strategic initiative to the Starbucks executive committee. The committee voted down the idea in a 7:1 vote. Starbucks CEO Howard Schultz commented, “We do coffee; we don’t do iced drinks.”

Diana, however, was undeterred. She experimented until she created the iced drink, and then she began to offer it in her store. When Behar visited Diana’s store, he was shocked to see this new drink on the menu—all Starbucks stores were supposed to

offer only company-approved drinks. But Diana told him the new drink was selling well.

Behar flew Diana’s team to Starbucks headquarters in Seattle to serve the iced-coffee drink to the executive committee. They liked its taste, but still said no. Then Behar pulled out the sales numbers that Diana had carefully kept. The drink was selling like crazy: 40 drinks a day the first week, 50 drinks a day the next week, and then 70 drinks a day in the third week after introduction. They had never seen such growth numbers. These results persuaded the executive team to give reluctant approval to introduce the drink in all Starbucks stores.

You’ve probably guessed by now that we’re talking about Starbucks Frappuccino. Frappuccino is now a multibillion-dollar business for Starbucks. At one point, this iced drink brought in more than 20 percent of Starbucks’s total revenues, which were \$23 billion in 2017.³³



©Ian Dagnall/Alamy Stock Photo

strategic initiative Any activity a firm pursues to explore and develop new products and processes, new markets, or new ventures.

autonomous actions Strategic initiatives undertaken by lower-level employees on their own volition and often in response to unexpected situations.

Functional managers such as Diana, the Starbucks store manager featured in Strategy Highlight 2.1, are much closer to the final products, services, and customers than the more removed corporate- or business-level managers. They also receive much more direct customer feedback. As a result, functional managers may start strategic initiatives based on autonomous actions that can influence the direction of the company. To be successful, however, top-level executives need to support emergent strategies that they believe fit with the firm’s vision and mission. Diana’s autonomous actions might not have succeeded or might have got her in trouble if she did not garner the support of a senior Starbucks executive. This executive championed her initiative and helped persuade other top executives. *Internal champions*, therefore, are often needed for autonomous actions to be successful.

Although emergent strategies can arise in the most unusual circumstances, it is important to emphasize the role that top management teams play in this type of strategy process. In the strategy-as-planned-emergence approach, executives need to decide which of the bottom-up initiatives to pursue and which to shut down. This critical decision is made on the basis of whether the strategic initiative fits with the company’s vision and mission, and whether it provides an opportunity worth exploiting. Executives, therefore, continue to play a critical role in the potential success or failure of emergent strategies because they determine how limited resources are allocated.

After initial resistance, as detailed in Strategy Highlight 2.1, the Starbucks executive team around CEO Howard Schultz fully supported the Frappuccino strategic initiative, providing the resources and personnel to help it succeed. During his tenure at General Electric, then CEO Jeffrey Immelt decided to move ahead with a strategic initiative to buy the wind energy company Enron Wind from the bankruptcy proceedings of Enron because he saw the

acquisition as supporting the company's vision and mission.³⁴ But the initiative only survived to get Immelt's attention because of the tireless persistence of a mid-level engineer who saw its future value. GE provided appropriate resources and structures to grow this emergent strategy into a major strategic initiative that's now worth billions of dollars.

SERENDIPITY. *Serendipity* describes random events, pleasant surprises, and accidental happenstances that can have a profound impact on a firm's strategic initiatives.

There are dozens of examples where serendipity had a crucial influence on the course of business and entire industries. The discovery of 3M's Post-it Notes or Pfizer's Viagra, first intended as a drug to treat hypertension, are well known.³⁵ Less well known is the discovery of potato chips.³⁶ The story goes that in the summer of 1853, George Crum was working as a cook at the Moon Lake Lodge resort in Saratoga Springs, New York. A grumpy patron ordered Moon resort's signature fried potatoes. These potatoes were served in thick slices and eaten with a fork as was in the French tradition. When the patron received the fries, he immediately returned them to the kitchen, asking for them to be cut thinner. Crum prepared a second plate in order to please the patron, but this attempt was returned as well. The third plate was prepared by an annoyed Crum who, trying to mock the patron, sliced the potatoes sidewise as thin as he could and fried them. Instead of being offended, the patron was ecstatic with the new fries and suddenly other patrons wanted to try them as well. Crum later opened his own restaurant and offered the famous "Saratoga Chips," which he set up in a box and some customers simply took home as a snack to be eaten later. Today, PepsiCo's line of Frito-Lay's chips are a multibillion-dollar business.

How do strategic leaders create a work environment in which autonomous actions and serendipity can flourish? One approach is to provide time and resources for employees to pursue other interests. Google, the online search and advertising subsidiary of Alphabet, for example, organizes the work of its engineers according to a 70-20-10 rule. The majority of the engineers' work time (70 percent) is focused on its main business (search and ads).³⁷ Google also allows its engineers to spend one day a week (20 percent) on ideas of their own choosing, and the remainder (10 percent) on total wild cards such as a Project Loon, which places high-altitude balloons into the stratosphere to create a high-speed wireless network with global coverage. Google reports that half of its new products and services came from the 20 percent rule, including Gmail, Google Maps, Google News, and Orkut.³⁸ With the restructuring of Google into a corporation with multiple strategic business units, engineers spending their 10 percent time on total wild cards do so within Google X, its research and development unit.³⁹

RESOURCE-ALLOCATION PROCESS. A firm's **resource-allocation process (RAP)** determines the way it allocates its resources and can be critical in shaping its realized strategy.⁴⁰ Emergent strategies can result from a firm's resource-allocation process (RAP).⁴¹ Intel Corp. illustrates this concept.⁴² Intel was created to produce DRAM (dynamic random-access memory) chips. From the start, producing these chips was the firm's top-down strategic plan, and initially it worked well. In the 1980s, Japanese competitors brought better-quality chips to the market at lower cost, threatening Intel's position and obsoleting its top-down strategic plan. However, Intel was able to pursue a strategic transformation because of the way it set up its resource-allocation process. In a sense, Intel was using functional-level managers to drive business and corporate strategy in a bottom-up fashion. In particular, during this time Intel had only a few fabrication plants (called "fabs") to produce silicon-based products. It would have taken several years and billions of dollars to build additional capacity by bringing new fabs online.

With constrained capacity, Intel had implemented the production-decision rule *to maximize margin-per-wafer-start*. Each time functional managers initiated a new production run, they

serendipity Any random events, pleasant surprises, and accidental happenstances that can have a profound impact on a firm's strategic initiatives.

resource-allocation process (RAP) The way a firm allocates its resources based on predetermined policies, which can be critical in shaping its realized strategy.

were to consider the profit margins for DRAM chips and for microprocessors, the “brains” of personal computers. The operations managers then could produce *whichever product* delivered the higher margin. By following this simple rule, front-line managers shifted Intel’s production capacity away from the lower-margin DRAM business to the higher-margin microprocessors business. The firm’s focus on microprocessors emerged from the bottom up, based on resource allocation. Indeed, by the time top management finally approved the de facto strategic switch, the company’s market share in DRAM had dwindled to less than 3 percent.⁴³

Taken together, a firm’s realized strategy is frequently a combination of top-down strategic intent and bottom-up emergent strategies, as Exhibit 2.6 shows. This type of strategy process is called **planned emergence**. In that process, organizational structure and systems allow bottom-up strategic initiatives to emerge and be evaluated and coordinated by top management.⁴⁴ These bottom-up strategic initiatives can be the result of autonomous actions, serendipity, or the resource allocation process.

Exhibit 2.7 compares and contrasts the three different approaches to the strategic management process: top-down strategic planning, scenario planning, and strategy as planned emergence.

planned emergence Strategy process in which organizational structure and systems allow bottom-up strategic initiatives to emerge and be evaluated and coordinated by top management.

EXHIBIT 2.7 / Comparing and Contrasting Top-Down Strategic Planning, Scenario Planning, and Strategy as Planned Emergence

Strategy Process	Description	Pros	Cons	Where Best Used
Top-Down Strategic Planning	A rational strategy process through which top management attempts to program future success; typically concentrates strategic intelligence and decision-making responsibilities in the office of the CEO.	• Provides a clear strategy process and lines of communication. • Affords coordination and control of various business activities. • Readily accepted and understood as process is well established and widely used. • Works relatively well in stable environments.	• Fairly rigid and inhibits flexibility. • Top-down, one-way communication limits feedback. • Assumes that the future can usually be predicted based on past data. • Separates elements of AFI framework so that top management (analysis & formulation) are removed from line employees (implementation).	• Highly regulated and stable industries such as utilities, e.g., Georgia Power in Southeast United States or Areva, state-owned nuclear operator in France. • Government • Military
Scenario Planning	Strategy-planning activity in which top management envisions different what-if scenarios to anticipate plausible futures in order to plan optimal strategic responses.	• Provides a clear strategy process and lines of communication. • Affords coordination and control of various business activities. • Readily accepted and understood as process is well established and widely used. • Provides some strategic flexibility.	• Top-down, one-way communication limits feedback. • Separates elements of AFI framework so that top management (analysis & formulation) are removed from line employees (implementation). • As the future is unknown, responses to all possible events cannot be planned. • Leaders tend to avoid planning for pessimistic scenarios.	• Fairly stable industries, often characterized by some degree of regulation such as airlines, logistics, or medical devices, e.g., American Airlines, Delta Air Lines, and United Airlines; FedEx and UPS; Medtronic. • Larger firms in industries with a small number of other large competitors (oligopoly).

Strategy Process	Description	Pros	Cons	Where Best Used
Strategy as Planned Emergence	Blended strategy process in which organizational structure and systems allow both top-down vision and bottom-up strategic initiatives to emerge for evaluation and coordination by top management.	- Combines all elements of the AFI framework in a holistic and flexible fashion. - Provides provisional direction through intended strategy. - Accounts for unrealized strategy (not all strategic initiatives can be implemented). - Accounts for emergent strategy (good ideas for strategic initiatives can bubble up from lower levels of hierarchy through autonomous actions, serendipity, and RAP). - The firm's realized strategy is a combination of intended and emergent strategy. - Highest degree of strategic flexibility and buy-in by employees.	- Unclear strategy process and lines of communication can lead to employee confusion and lack of focus. - Many ideas that bubble up from the bottom may not be worth pursuing. - Firms may lack a clear process of how to evaluate emergent strategy, increasing the chances of missing mega opportunities or pursuing dead ends; may also contribute to employee frustration and lower morale.	- New ventures and smaller firms. - High-velocity industries such as technology ventures. - Internet companies; e.g., Airbnb, Alibaba, Alphabet (parent company of Google), Amazon, Facebook, Twitter, and Uber. - Biotech companies; e.g., Amgen, Biogen, Gilead Sciences, Genentech, and Genzyme.

2.3 Stakeholders and Competitive Advantage

Companies with a good strategy generate value for society. When firms compete in their own self-interest while obeying the law and acting ethically, they ultimately create value. Value creation occurs because companies with a good strategy are able to provide products or services to consumers at a price point that they can afford while making a profit at the same time. Both parties benefit from this trade as each captures a part of the value created. In so doing, they leave society better off.⁴⁵

Value creation in turn lays the foundation for the benefits that successful economies can provide: education, infrastructure, public safety, health care, clean water and air, among others. Superior performance allows a firm to reinvest some of its profits and to grow, which in turn provides more opportunities for employment and fulfilling careers. Although Google (a division of Alphabet) started as a research project in graduate school by Larry Page and Sergey Brin in the late 1990s, some 20 years later it had become one of the most valuable companies in the world with some \$650 billion in market capitalization and over 75,000 employees, not to mention the billions of people across the world who rely on it for information gathering and decision making, which is free for the user.⁴⁶

LO 2-5

Assess the relationship between stakeholder strategy and sustainable competitive advantage.

Strategic failure, in contrast, can be expensive. Once a leading technology company, Hewlett-Packard was known for innovation, resulting in superior products. The “HP way of management” included lifetime employment, generous benefits, work/life balance, and freedom to explore ideas, among other perks.⁴⁷ However, HP has not been able to address the competitive challenges of mobile computing or business IT services effectively. As a result, HP’s stakeholders suffered. Shareholder value was destroyed massively. The company also had to lay off tens of thousands of employees. Its customers no longer received the innovative products and services that made HP famous.

The contrasting examples of Alphabet and HP illustrate the relationship between individual firms, competitive advantage, and society at large. Successful firms ultimately create value for society. Recently, this relationship received more critical scrutiny due to major shocks to free market capitalism.⁴⁸ In particular, the implicit trust relationship between the corporate world and society at large has deteriorated because of the arrival of several *black swans*. One of the first black swan events of the 21st century occurred when the accounting scandals at Enron, Arthur Andersen, WorldCom, Tyco, Adelphia, and others, came to light. Those events led to bankruptcies, large-scale job loss, and the destruction of billions of dollars in shareholder value. As a result, the public’s trust in business and free market capitalism began to erode.

Another black swan event occurred in the fall of 2008 with the global financial crisis, which shook the entire free market system to its core.⁴⁹ A real estate bubble had developed in the United States, fueled by cheap credit and the availability of subprime mortgages. When that bubble burst, many entities faced financial duress or bankruptcy—those who had unsustainable mortgages, investors holding securities based on those mortgages, and the financial institutions that had sold the securities. Some went under, and others were sold at fire-sale prices. Home foreclosures skyrocketed as a large number of borrowers defaulted on their mortgages. House prices in the United States plummeted by roughly 30 percent. The United States plunged into a deep recession. In the process, the Dow Jones Industrial Average (DJIA) lost about half its market value.

The impact was worldwide. The freezing of capital markets during the global financial crisis triggered a debt crisis in Europe. Some European governments (notably Greece) defaulted on government debt; other countries were able to repay their debts only through the assistance of other, more solvent European countries. This severe financial crisis not only put Europe’s common currency, the euro, at risk, but also led to a prolonged and deep recession in Europe. In the United States, the Occupy Wall Street protest movement was born out of dissatisfaction with the capitalist system. Issues of income disparity, corporate ethics, corporate influence on governments, and ecological sustainability were key drivers.

Although these black swan events in the business world differed in their specifics, two common features are pertinent to our study of strategic management.⁵⁰ First, these events demonstrate that managerial actions can affect the economic well-being of large numbers of people around the globe. Most of the events resulted from executive actions (or inactions) within a few organizations, or compounded across a specific industry or government. The second pertinent feature relates to **stakeholders**—organizations, groups, and individuals that can affect or be affected by a firm’s actions.⁵¹ This leads us to *stakeholder strategy*, which we discuss next.

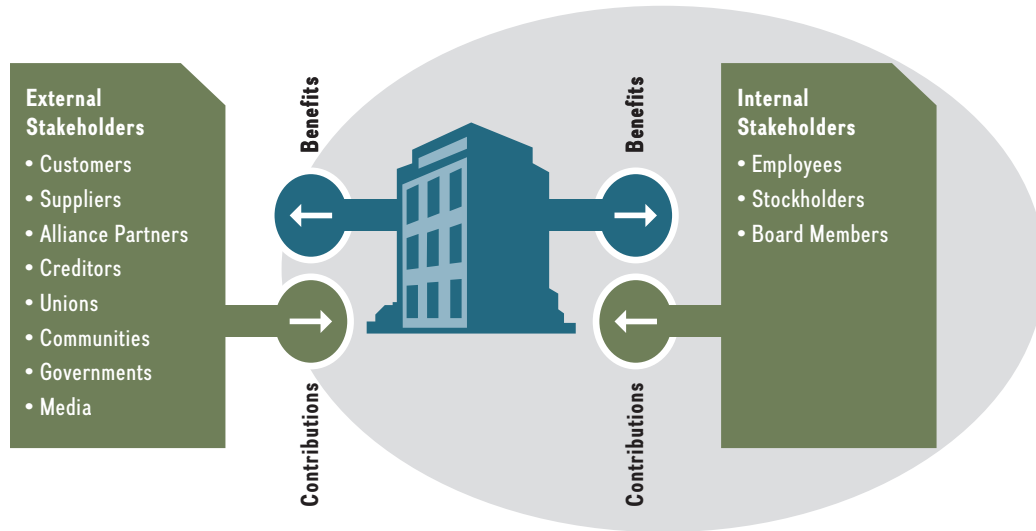
stakeholders

Organizations, groups, and individuals that can affect or be affected by a firm’s actions.

STAKEHOLDER STRATEGY

Stakeholders have a vested claim or interest in the performance and continued survival of the firm. Stakeholders can be grouped by whether they are internal or external to a firm. As shown in Exhibit 2.8, *internal stakeholders* include employees (including executives, managers, and workers), stockholders, and board members. *External stakeholders* include

EXHIBIT 2.8 / Internal and External Stakeholders in an Exchange Relationship with the Firm



customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.

All stakeholders make specific contributions to a firm, which in turn provides different types of benefits to different stakeholders. Employees contribute their time and talents to the firm, receiving wages and salaries in exchange. Shareholders contribute capital in the hope that the stock will rise and the firm will pay dividends. Communities provide real estate, infrastructure, and public safety. In return, they expect that companies will pay taxes, provide employment, and not pollute the environment. The firm, therefore, is embedded in a multifaceted *exchange relationship* with a number of diverse internal and external stakeholders.

If any stakeholder withholds participation in the firm's exchange relationships, it can negatively affect firm performance. The aerospace company Boeing, for example, has a long history of acrimonious labor relations, leading to walk-outs and strikes. This in turn has not only delayed production of airplanes but also raised costs. Or think about the different stakeholders in the global financial crisis discussed above. Borrowers who signed up for subprime mortgages are stakeholders (in this case, customers) of financial institutions. When they defaulted in large numbers, they threatened the survival of these financial institutions and, ultimately, of the entire financial system.

Stakeholder strategy is an integrative approach to managing a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.⁵² The unit of analysis is the web of exchange relationships a firm has with its stakeholders (see Exhibit 2.8). Stakeholder strategy allows firms to analyze and manage how various external and internal stakeholders interact to jointly create and trade value.⁵³ A core tenet of stakeholder strategy is that a single-minded focus on shareholders alone exposes a firm to undue risks. Simply putting shareholder interest above all else can undermine economic performance and even threaten the very survival of the enterprise. A strategic leader, therefore, must understand the complex web of exchange relationships among different stakeholders. With that understanding, the firm can proactively shape the various relationships to maximize the joint value created and manage the distribution of this larger pie in a fair and transparent manner. Effective stakeholder management exemplifies how strategic leaders can act

stakeholder strategy An integrative approach to managing a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.

to improve firm performance, thereby enhancing the firm's competitive advantage and the likelihood of its continued survival.⁵⁴

Taken together, strategy scholars have provided several arguments as to why effective stakeholder management can benefit firm performance.⁵⁵

- Satisfied stakeholders are more cooperative and thus more likely to reveal information that can further increase the firm's value creation or lower its costs.
- Increased trust lowers the costs for firms' business transactions.
- Effective management of the complex web of stakeholders can lead to greater organizational adaptability and flexibility.
- The likelihood of negative outcomes can be reduced, creating more predictable and stable returns.
- Firms can build strong reputations that are rewarded in the marketplace by business partners, employees, and customers. Most managers do care about public perception of the firm, and frequently celebrate and publicize high-profile rankings such as the "World's Most Admired Companies" published annually by *Fortune*.⁵⁶ In 2016, the top five companies in this ranking were Apple, Alphabet, Amazon, Berkshire Hathaway (the conglomerate led by Warren Buffett), and Disney. Because of its continued innovation in products, services, and delivery, Apple has been ranked as the world's most admired company for the past several years by *Fortune*.

LO 2-6

Conduct a stakeholder impact analysis.

stakeholder impact analysis A decision tool with which managers can recognize, prioritize, and address the needs of different stakeholders, enabling the firm to achieve competitive advantage while acting as a good corporate citizen.

STAKEHOLDER IMPACT ANALYSIS

The key challenge of stakeholder strategy is to effectively balance the needs of various stakeholders. The firm needs to ensure that its primary stakeholders—the firm's shareholders and other investors—achieve their objectives. At the same time, the firm needs to recognize and address the concerns of other stakeholders—employees, suppliers, and customers—in an ethical and fair manner, so that they too are satisfied. This all sounds good in theory, but how can strategic leaders go about this in practice?

Stakeholder impact analysis provides a decision tool with which strategic leaders can recognize, prioritize, and address the needs of different stakeholders. This tool helps the firm achieve a competitive advantage while acting as a good corporate citizen. Stakeholder impact analysis takes strategic leaders through a five-step process of recognizing stakeholders' claims. In each step, they must pay particular attention to three important stakeholder attributes: *power*, *legitimacy*, and *urgency*.⁵⁷

- A stakeholder has *power* over a company when it can get the company to do something that it would not otherwise do.
- A stakeholder has a *legitimate claim* when it is perceived to be legally valid or otherwise appropriate.
- A stakeholder has an *urgent claim* when it requires a company's immediate attention and response.

Exhibit 2.9 depicts the five steps in stakeholder impact analysis and the key questions to be asked. Let's look at each step in detail.

STEP 1: IDENTIFY STAKEHOLDERS. In Step 1, strategic leaders ask, "Who are our stakeholders?" In this step, the strategic leaders focus on stakeholders that currently have, or potentially can have, a material effect on a company. This prioritization identifies the most powerful internal and external stakeholders as well as their needs. For public-stock companies, key stakeholders are the shareholders and other providers of capital. If shareholders



are not satisfied with returns to investment, they will sell the company's stock, leading to a fall in the firm's market value. If this process continues, it can make the company a takeover target, or launch a vicious cycle of continued decline.

A second group of stakeholders includes customers, suppliers, and unions. Local communities and the media are also powerful stakeholders that can affect the smooth operation of the firm. Any of these groups, if their needs are not met, can materially affect the company's operations.

For example, Boeing opened a new airplane factory in South Carolina to move production away from its traditional plant near Seattle, Washington. South Carolina is one of 28 states in the United States that falls under the right-to-work law in which employees in unionized workplaces are allowed to work without being required to join the union. In contrast to its work force in Washington state, the South Carolina plant is nonunionized, which should lead to fewer work interruptions due to strikes and Boeing hopes to higher productivity and improvements along other performance dimensions (like on-time delivery of new airplanes). In 2014, Boeing announced that its new 787 Dreamliner jet would be exclusively built in its nonunionized South Carolina factory.⁵⁸

STEP 2: IDENTIFY STAKEHOLDERS' INTERESTS. In Step 2, strategic leaders ask, "What are our stakeholders' interests and claims?" Managers need to specify and assess the interests and claims of the pertinent stakeholders using the power, legitimacy, and urgency criteria introduced earlier. As the legal owners, shareholders have the most legitimate claim on a company's profits. However, the wall separating the claims of ownership (by shareholders) and of management (by employees) has been eroding. Many companies incentivize top executives by paying part of their overall compensation with stock options. They also turn employees into shareholders through *employee stock ownership plans (ESOPs)*. These plans allow employees to purchase stock at a discounted rate or use company stock as an investment vehicle for retirement savings. For example, Alphabet, Coca-Cola, Facebook, Microsoft, Southwest Airlines, Starbucks, and Walmart all offer ESOPs. Clearly, the claims and interests of stakeholders who are employed by the company, and who depend on the company for salary and other benefits, will be somewhat different from those of stakeholders who merely own stock. The latter are investors who are primarily interested in the increased value of their stock holdings

through appreciation and dividend payments. Executives, managers, and workers tend to be more interested in career opportunities, job security, employer-provided health care, paid vacation time, and other perks.

Even within stakeholder groups there can be significant variation in the power a stakeholder may exert on the firm. For example, public companies pay much more attention to large investors than to the millions of smaller, individual investors. *Shareholder activists*, such as Bill Ackman, Carl Icahn, or T. Boone Pickens, tend to buy equity stakes in a corporation that they believe is underperforming to put public pressure on a company to change its strategy. Examples include the takeover battle at Dell Computer (which founder Michael Dell subsequently took private), the pressure on PepsiCo to spin off its Frito-Lay brand, or on Yahoo to sell itself to Verizon, which it did. Even top-performing companies are not immune to pressure by shareholder activists.⁵⁹ As a result of a sustained competitive advantage over the last decade, Apple had not only become the most valuable company on the planet but also amassed some \$200 billion in cash in the process. Apple CEO Tim Cook faced significant pressure from Carl Icahn, who held roughly \$4 billion worth of Apple stock, to buy back more of its shares and thus to further raise Apple's share price. Cook obliged, and Apple bought back a significant amount of stock, using its cash to buttress its share price.

Although both individual and activist investors may claim the same legitimacy as stockholders, shareholder activists have much more power over a firm. They can buy and sell a large number of shares at once, or exercise block-voting rights in the *corporate governance process* (which we'll discuss in detail in Chapter 12). Shareholder activists frequently also demand seats on the company's board to more directly influence its corporate governance, and with it exert more pressure to change a company's strategy. These abilities make activist investors powerful stakeholders, with urgent and legitimate claims.

STEP 3: IDENTIFY OPPORTUNITIES AND THREATS. In Step 3, strategic leaders ask, "What opportunities and threats do our stakeholders present?" Since stakeholders have a claim on the company, opportunities and threats are two sides of the same coin. Consumer boycotts, for example, can be a credible threat to a company's behavior. Some consumers boycotted Nestlé products when the firm promoted infant formula over breast milk in developing countries. PETA⁶⁰ called for a boycott of McDonald's due to alleged animal-rights abuses.

In the best-case scenario, managers transform such threats into opportunities. Sony Corp. of Japan, for example, was able to do just that.⁶¹ During one holiday season, the Dutch government blocked Sony's entire holiday season shipment of PlayStation game systems, valued at roughly \$500 million, into the European Union because of a small but legally unacceptable amount of toxic cadmium discovered in one of the system's cables. This incident led to an 18-month investigation in which Sony inspected over 6,000 supplier factories around the world to track down the source of the problem. The findings allowed Sony to redesign and develop a cutting-edge supplier management system that now adheres to a stringent extended value chain responsibility.

STEP 4: IDENTIFY SOCIAL RESPONSIBILITIES. In Step 4, strategic leaders ask, "What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?" To identify these responsibilities more effectively, scholars have advanced the notion of **corporate social responsibility (CSR)**. This framework helps firms recognize and address the economic, legal, ethical, and philanthropic expectations that society has of the business enterprise at a given point in time.⁶² According to the CSR perspective, strategic

corporate social responsibility (CSR)

A framework that helps firms recognize and address the economic, legal, social, and philanthropic expectations that society has of the business enterprise at a given point in time.

leaders need to realize that society grants shareholders the right and privilege to create a publicly traded stock company. Therefore, the firm owes something to society.⁶³ CSR provides strategic leaders with a conceptual model that more completely describes a society's expectations and can guide strategic decision making more effectively. In particular, CSR has four components:

- Economic responsibilities
- Legal responsibilities
- Ethical responsibilities
- Philanthropic responsibilities⁶⁴

Economic Responsibilities. The business enterprise is first and foremost an economic institution. Investors expect an adequate return for their risk capital. Creditors expect the firm to repay its debts. Consumers expect safe products and services at appropriate prices and quality. Suppliers expect to be paid in full and on time. Governments expect the firm to pay taxes and to manage natural resources such as air and water under a decent stewardship. To accomplish all this, firms must obey the law and act ethically in their quest to gain and sustain competitive advantage.

Nobel laureate Milton Friedman views the economic responsibility of the firm as its primary objective, as captured in his famous quote: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."⁶⁵

Legal Responsibilities. Laws and regulations are a society's codified ethics, embodying notions of right and wrong. They also establish the rules of the game. For example, business as an institution can function because property rights exist and contracts can be enforced in courts of law. Strategic leaders must ensure that their firms obey all the laws and regulations, including but not limited to labor, consumer protection, and environmental laws.

One far-reaching piece of U.S. legislation in terms of business impact, for example, is the Patient Protection and Affordable Care Act (PPACA), more commonly known as the Affordable Care Act (ACA) or Obamacare. Key provisions of this federal law include, among others, that firms with 50 or more full-time employees must offer affordable health insurance to their employees and dependents, or pay a fine for each worker. This makes it harder for entrepreneurs to grow their ventures above this threshold. One reaction of many small businesses has been to reduce the number of full-time workers to 49 employees and add part-time employees only, which do not fall under this provision. Another reaction of employers is to offer lower wages to compensate for higher health care costs. Moreover, health insurance providers are no longer allowed to deny coverage based on preexisting medical conditions. As a consequence, health care premiums have been rising as the overall risk pool of insurers is less healthy.⁶⁶

Ethical Responsibilities. Legal responsibilities, however, often define only the minimum acceptable standards of firm behavior. Frequently, strategic leaders are called upon to go beyond what is required by law. The letter of the law cannot address or anticipate all possible business situations and newly emerging concerns such as internet privacy or advances in DNA testing, genetic engineering, and stem-cell research.

A firm's ethical responsibilities, therefore, go beyond its legal responsibilities. They embody the full scope of expectations, norms, and values of its stakeholders. Strategic

EXHIBIT 2.10 /

The Pyramid of Corporate Social Responsibility

SOURCE: Adapted from Carroll, A. B. (1991), "The pyramid of corporate social responsibility: Toward the moral management of organizational stakeholders," *Business Horizons*, July–August, 42.



leaders are called upon to do what society deems just and fair. Starbucks, for example, developed an ethical sourcing policy to help source coffee of the highest quality, while adhering to fair trade and responsible growing practices. On the other hand, Starbucks has been criticized for not paying an adequate amount of taxes in the United Kingdom. Albeit entirely legal, Starbucks did pay very little in corporate income taxes since opening its first store in the United Kingdom in 1998 (around \$13.5 million total). In an attempt to silence the critics, to stop protests, and to please the British government, Starbucks volunteered an additional tax payment of \$16 million for the 2013–14 tax year, despite having no legal obligation to do so.⁶⁷

Philanthropic Responsibilities. Philanthropic responsibilities are often subsumed under the idea of *corporate citizenship*, reflecting the notion of voluntarily giving back to society. Over the years, Microsoft's corporate philanthropy program has donated more than \$3 billion in cash and software to people who can't afford computer technology.⁶⁸

The pyramid in Exhibit 2.10 summarizes the four components of corporate social responsibility.⁶⁹ Economic responsibilities are the foundational building block, followed by legal, ethical, and philanthropic responsibilities. Note that society and shareholders *require* economic and legal responsibilities. Ethical and philanthropic responsibilities result from a society's expectations toward business. The pyramid symbolizes the need for firms to carefully balance their social responsibilities. Doing so ensures not only effective strategy implementation, but also long-term viability.

STEP 5: ADDRESS STAKEHOLDER CONCERNS. Finally, in Step 5, the firm asks, "What should we do to effectively address any stakeholder concerns?" In the last step in stakeholder impact analysis, strategic leaders need to decide the appropriate course of action for the firm, given all of the preceding factors. Thinking about the attributes of power, legitimacy, and urgency helps to prioritize the legitimate claims and to address them accordingly. Strategy Highlight 2.2 describes how the U.S. government legitimized claims by thousands of businesses and individuals in the aftermath of the BP oil spill in the Gulf of Mexico, causing the claims to become of great urgency to BP.

Strategy Highlight 2.2

BP “Grossly Negligent” in Gulf of Mexico Disaster

On April 20, 2010, an explosion occurred on BP’s Deepwater Horizon oil drilling rig off the Louisiana coastline, killing 11 workers. The subsequent oil spill continued unabated for over three months. It released an estimated 5 million barrels of crude oil into the Gulf of Mexico, causing the largest environmental disaster in U.S. history. Two BP employees even faced manslaughter charges. The cleanup alone cost BP \$14 billion. Because of the company’s haphazard handling of the crisis, Tony Hayward, BP’s CEO at the time, was fired.

Technical issues aside, many experts argued that BP’s problems were systemic, because BP’s strategic leaders had repeatedly failed to put an adequate safety culture in place. In 2005, for example, BP experienced a catastrophic accident at a Texas oil refinery, which killed 15 workers. A year later, a leaking BP pipeline caused the largest oil spill ever on Alaska’s North Slope. BP’s strategic focus on cost reductions, initiated by its strategic leaders a few years earlier, may have significantly compromised safety across the board. In a fall 2014 ruling, a federal judge declared that BP’s measures to cut costs despite safety risks “evinced an extreme deviation from the standard of care and a conscious disregard of known risks.”⁷⁰

In the aftermath of the oil spill, BP faced thousands of claims by many small-business owners in the tourism and

seafood industries. These business owners were not powerful individually, and pursuing valid legal claims meant facing protracted and expensive court proceedings. As a collective organized in a class-action lawsuit, however, they were powerful. Moreover, their claims were backed by the U.S. government, which has the power to withdraw BP’s business license or cancel current permits and withhold future ones. Collectively, the small-business owners along the Gulf Coast became powerful BP stakeholders, with a legitimate and urgent claim that needed to be addressed. In response, BP agreed to pay over \$25 billion to settle their claims and cover other litigation costs.

Even so, this was not the end of the story for BP. The oil company was found to have committed “gross negligence” (reckless and extreme behavior) by a federal court. Additional fines and other environmental costs added another \$8.5 billion. BP’s total tab for the Gulf of Mexico disaster was \$56 billion! BP CEO Bob Dudley sold about



SOURCE: U.S. Coast Guard

\$40 billion in assets, turning BP into a smaller company that aims to become more profitable in coming years.

Moreover, claiming that BP displayed a “lack of business integrity” in handling the gulf oil spill, the Environmental Protection Agency (EPA) banned BP from any new contracts with the U.S. government. This put BP at a major competitive disadvantage, because it is unable to acquire new leases for oil field exploration in the United States, or to continue as a major supplier of refined fuel to the armed forces, among other federal contracts.⁷¹

2.4 Implications for Strategic Leaders

Executives whose vision and decisions enable their organizations to achieve competitive advantage demonstrate *strategic leadership*. Effective strategic leaders use position as well as informal power and influence to direct the activities of others when implementing the organization’s strategy. To gain and sustain a competitive advantage, strategic leaders need to put an effective *strategic management process* in place. They need to design a process

that supports strategy formulation and implementation. In particular, strategic leaders have three options in their strategic toolkit: top-down strategic planning, scenario planning, and strategy as planned emergence. Each of the three strategy processes has its strengths and weaknesses.

Strategic leaders also need to consider the rate of change and firm size, both of which factors affect the effectiveness of a chosen strategy process. The rate of change, internally and externally, can suggest the more useful planning approach. In a slow-moving and stable environment, top-down strategic planning might be the most effective. In a fast-moving and changeable environment, strategy as planned emergence might be the most effective. As to firm size, larger firms tend to use either a top-down strategic planning process or scenario planning. Smaller firms may find it easier to implement strategy as planned emergence when feedback loops are short and the ability to respond quickly is keen.

For instance, a nuclear power provider such as Areva in France, providing over 75 percent of the country's energy and with the long-term backing of the state, might do well using a top-down strategy approach. Take the issue of disaster planning. Nuclear accidents, while rare, have a tremendous impact as seen in Chernobyl, Russia, and Fukushima, Japan, so power providers need to be prepared. Areva might use scenario planning to prepare for such a black swan event. Contrast this with fast-moving environments. Internet-based companies, such as Alibaba, Alphabet, Amazon, Facebook, or Uber, tend to use strategy as planned emergence. In this process, every employee plays a strategic role. When a firm is using top-down planning or scenario planning, lower-level employees focus mainly on strategy implementation. As the examples in this chapter have shown, however, *any employee*, even at the entry level, can have great ideas that might become *strategic initiatives* with the potential to transform companies.

Strategic leaders are also mindful of the organization's internal and external *stakeholders*, because they have a vested claim or interest in the performance and continued survival of the firm. Using a *stakeholder strategy approach* enables strategic leaders to manage a diverse set of stakeholders effectively in order to gain and sustain competitive advantage.

Here we conclude our discussion of the strategic management process, which marks the end of the "getting started" portion of the AFI framework. The next three chapters cover the analysis part of the framework, where we begin by studying external and internal analyses before taking a closer look at competitive advantage, firm performance, and business models.

CHAPTERCASE 2 / Consider This . . .

During her decade as a strategic leader at Facebook, Sheryl Sandberg has seen the firm become the most successful social network ever, anywhere. But Facebook has new challenges.

First, there are continued concerns about user privacy. Facebook has long been criticized for alleged lax handling of user information and an opaque privacy policy that changed frequently. More recently, the hot-button privacy issue came up again as Facebook stopped merging the user data obtained from the messaging app WhatsApp, which it bought for almost \$20 billion in 2014, with its own. In response to a

court ruling in Germany, Facebook announced it would pause the ongoing merging process. This, however, will decrease Facebook's ability to finely target its ads based on a user's fine-grained social profile.

Next, critics attacked Facebook for the rise of fake news items populating users' news



Facebook CEO Mark Zuckerberg and Facebook COO Sheryl Sandberg.

(left): ©David Ramos/Getty Images, (right): ©Justin Sullivan/Getty Images

feeds. This rise stems from Facebook's algorithms that give prominence to information with higher user engagement. Outrageous headlines—a hallmark of fake news items—solicit high levels of user interest. Some critics complained that populating news feeds with misinformation skewed the outcome of the 2016 U.S. presidential election. CEO Mark Zuckerberg dismissed this charge as a “pretty crazy idea.” Nonetheless, Facebook decided to follow Google's lead and to bar fake news sites from using its online advertising, thereby reducing their prominence.

The issue of fake news in some ways points to a larger crisis: The ever louder criticism that Facebook is now more a news organization than a simple social network. Critics want to see a higher degree of responsibility, similar to that shown by traditional publishers. Roughly half of Americans of all ages (and a higher percentage of youth) get their political news on Facebook. Facebook maintains that it is agnostic on news content (real news, anyway). Sandberg has publicly addressed the fake news issue directly, but less so Facebook's responsibilities as a new kind of news publisher.

The issue may not go away. It did not help Facebook's case that in late 2016 news broke that Facebook had already developed a censorship tool, one that could be used to let the firm monitor news for quality control. Apparently the censorship tool is meant to persuade China to let Facebook back

into the country. In China, access to news is heavily managed by the state; China is potentially the largest single online market in the world.⁷²

Questions

1. Describe Sheryl Sandberg's strategic leadership. Which qualities stand out to you, and why? Is she an effective strategy leader? Why, or why not?
2. What current challenges (as detailed in this ChapterCase) is Facebook facing? How should Sandberg deal with each of them? Please make specific recommendations.
3. What are the main issues Sandberg brings to the fore in her TED talk, titled “Why We Have Too Few Women Leaders”? You can view the 15-minute talk here: <http://bit.ly/1czSD6n>. How can your awareness of these issues help you to be a more effective strategic leader? How can these issues be addressed?
4. Rumors persist that Sandberg might pursue a political career in the future (she was chief of staff to Larry Summers, former Treasury secretary under President Bill Clinton). Do you think Sandberg would make a good politician? Do you think the required qualities of strategic leadership are the same or similar in business and politics? Why or why not? Support your arguments.

TAKE-AWAY CONCEPTS

This chapter examined the role strategic leaders play, delineated different processes to create strategy, and explained how to conduct a stakeholder impact analysis. We summarize the discussion in the following learning objectives and related take-away concepts.

LO 2-1 / Explain the role of strategic leaders and what they do.

- Executives whose vision and decisions enable their organizations to achieve competitive advantage demonstrate strategic leadership.
- Strategic leaders use formal and informal power to influence the behavior of other organizational members to do things, including things they would not do otherwise.

- Strategic leaders can have a strong (positive or negative) performance impact on the organizations they lead.

LO 2-2 / Outline how you can become a strategic leader.

- To become an effective strategic leader, you need to develop skills to move sequentially through five different leadership levels: highly capable individual, contributing team member, competent manager, effective leader, and executive (see Exhibit 2.2)
- The Level-5 strategic leadership pyramid applies to both distinct corporate positions and personal growth.

LO 2-3 / Describe the roles of corporate, business, and functional managers in strategy formulation and implementation.

- *Corporate executives* must provide answers to the question of *where to compete*, whether in industries, markets, or geographies, and *how to create synergies* among different business units.
- *General managers* in strategic business units must answer the strategic question of *how to compete* in order to achieve superior performance. They must manage and align the firm's different functional areas for competitive advantage.
- *Functional managers* are responsible for *implementing business strategy* within a single functional area.

LO 2-4 / Evaluate top-down strategic planning, scenario planning, and strategy as planned emergence.

- Top-down strategic planning is a sequential, linear process that works reasonably well when the environment does not change much.
- In scenario planning, managers envision what-if scenarios and prepare contingency plans that can be called upon when necessary.
- Strategic initiatives can be the result of top-down planning or can emerge through a bottom-up process from deep within the organization. They have the potential to shape a firm's strategy.
- A firm's realized strategy is generally a combination of its top-down intended strategy and bottom-up emergent strategy, resulting in planned emergence.

LO 2-5 / Assess the relationship between stakeholder strategy and sustainable competitive advantage.

- *Stakeholders* are individuals or groups that have a claim or interest in the performance and

continued survival of the firm. They make specific contributions for which they expect rewards in return.

- *Internal stakeholders* include stockholders, employees (for instance, executives, managers, and workers), and board members.
- *External stakeholders* include customers, suppliers, alliance partners, creditors, unions, communities, governments at various levels, and the media.
- Several recent black swan events eroded the public's trust in business as an institution and in free market capitalism as an economic system.
- The effective management of stakeholders is necessary to ensure the continued survival of the firm and to sustain any competitive advantage. This is achieved through *stakeholder strategy*.

LO 2-6 / Conduct a stakeholder impact analysis.

- Stakeholder impact analysis considers the needs of different stakeholders, which enables the firm to perform optimally and to live up to the expectations of good citizenship.
- In a stakeholder impact analysis, managers pay particular attention to three important stakeholder attributes: power, legitimacy, and urgency.
- Stakeholder impact analysis is a five-step process that answers the following questions for the firm:
 1. Who are our stakeholders?
 2. What are our stakeholders' interests and claims?
 3. What opportunities and threats do our stakeholders present?
 4. What economic, legal, ethical, and philanthropic responsibilities do we have to our stakeholders?
 5. What should we do to effectively address the stakeholder concerns?

KEY TERMS

Autonomous actions (p. 43)

Black swan events (p. 40)

corporate social responsibility (CSR). (p. 52)

Dominant strategic plan (p. 41)

Emergent strategy (p. 43)

Illusion of control (p. 42)

Intended strategy (p. 42)

Level-5 leadership pyramid (p. 34)

Planned emergence (p. 46)

Realized strategy (p. 43)

Resource-allocation process (RAP) (p. 45)

Scenario planning (p. 39)

Serendipity (p. 45)

Stakeholders (p. 48)

Stakeholder impact analysis (p. 50)

Stakeholder strategy (p. 49)	Strategic leadership (p. 32)	Strategy implementation (p. 36)
Strategic business unit (SBU) (p. 37)	Strategic management process (p. 38)	Top-down strategic planning (p. 38)
Strategic initiative (p. 43)	Strategy formulation (p. 36)	Upper-echelons theory (p. 33)

DISCUSSION QUESTIONS

1. In what situations is top-down planning likely to be superior to bottom-up emergent strategy development?
2. This chapter introduces three levels appropriate for strategic considerations (see Exhibit 2.3). In what situations would some of these levels be more important than others? For example, what issues might be considered by the corporate level? What do you see as the primary responsibilities of corporate-level executives? When might the business-level managers bear more responsibility for considering how to respond to an issue?
3. In what situations might the functional-level managers have a primary responsibility for considering an issue? How should the organization ensure the proper attention to each level of strategy as needed?
3. Identify an industry that is undergoing intense competition or is being featured in the business press. Discuss how scenario planning might be used by companies to prepare for future events. Can some industries benefit more than others from this type of process? Explain why.

ETHICAL/SOCIAL ISSUES

1. BP's experience in the Gulf of Mexico has made it the poster company for how *not* to manage stakeholder relationships effectively (see Strategy Highlight 2.2). What advice would you give to BP's managers to help them continue to rebuild stakeholder relationships in the Gulf region and beyond? How can BP repair its damaged reputation? Brainstorm ways that top management might leverage the experience gained by reactions in the Gulf and use that knowledge to motivate local managers and employees in other locales to build stakeholder relationships proactively so that BP avoids this type of negative publicity.
2. This chapter discusses some of the key strategic leadership issues (such as privacy and fake news) facing Facebook leaders Sheryl Sandberg and Mark Zuckerberg. Consider other firms mentioned in the chapter such as Amazon, PepsiCo, Uber, VW, and Starbucks. What social and ethical issues do the leaders of these firms face today? Choose a firm or industry and explore the relevant controversial issues it faces. How should strategic leaders address the major issues you have identified?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

In many situations, promising ideas emerge from the lower levels of an organization, only to be discarded before they can be implemented. It was only extraordinary tenacity and disregard for the policy of selling only corporate-approved drinks that permitted the Frappuccino to "bloom" within Starbucks (see Strategy Highlight 2.1).

Some scholars have suggested that companies set aside up to 2 percent of their budgets for *any* manager with budget control to be able to invest in new ideas within the company.⁷³ Thus, someone with a \$100,000 annual budget to manage would be able to invest \$2,000 in cash or staff time toward such a project. Multiple managers could go in together for somewhat larger funds or time amounts. Through such a process,

the organization could generate a network of “angel investors.” Small funds or staff time could be invested in a variety of projects. Approval mechanisms would be easier for these small “seed-stock” ideas, to give them a chance to develop before going for bigger funding at the top levels of the organization.

What problems would need to be addressed to introduce this angel-network idea into a firm? Use a firm someone in your group has worked for or knows well to discuss possible issues of widely distributing small funding level approvals across the firm.

//// Small Group Exercise 2

Form small groups of three to four students. Search the internet on the following topic and debate your findings.

The chapter includes a discussion of black swan events that were improbable and unexpected yet had an extreme impact on the well-being of individuals,

firms, and nations. Nassim Nicholas Taleb, author of *The Black Swan*, has argued that policy makers and decision makers need to focus on building more robust organizations or systems rather than on improving predictions of events. This notion is reflected in the response to the predicted increase in powerful storms and storm surges. Hurricanes Katrina (which devastated New Orleans and parts of the Gulf Coast) and Sandy (which wreaked havoc on the New Jersey coast) have stimulated discussions about how to not only build a more resilient infrastructure and buildings, but also develop more flexible and effective responses.

For each group, search the internet for options and plans to (1) build more sustainable communities that would help areas cope with superstorms, or droughts, and (2) organize responses to black swan events more effectively. Brainstorm additional recommendations that you might make to policy makers.

mySTRATEGY

Who are your stakeholders?

How do you think about accomplishing your goals? One way to strategize your success is to use a version of the stakeholder impact analysis. On a personal level, your internal stakeholders might be immediate family members, and close personal friends. External stakeholders could be neighbors, peers, funding sources, and managers.

A key aspect presented in this chapter is to consider the point of view of a variety of stakeholders in meeting the goals of the firm. The same logic applies to many of your own personal or career goals as well. For instance, let's say you are close to graduating from a university. How do your stakeholders

view your job and career prospects? Do they want you to stay close to home? Do they encourage you to start a new business?

As noted in the chapter, stakeholders will have different points of view and also different levels of impact upon your successes or failures.

1. List your personal goals. Which stakeholders are supportive of these goals? Which are likely to try to block these goals?
2. Develop a plan to address key stakeholder concerns from each perspective. Can you find a pathway in the stakeholder analysis to build support for your key goals?
3. What would it take to implement your ideas/plans to move forward with these goals?

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CHAPTER

3

External Analysis: Industry Structure, Competitive Forces, and Strategic Groups

Chapter Outline

- 3.1 The PESTEL Framework**
 - Political Factors*
 - Economic Factors*
 - Sociocultural Factors*
 - Technological Factors*
 - Ecological Factors*
 - Legal Factors*
- 3.2 Industry Structure and Firm Strategy: The Five Forces Model**
 - Industry vs. Firm Effects in Determining Firm Performance*
 - Competition in the Five Forces Model*
 - The Threat of Entry*
 - The Power of Suppliers*
 - The Power of Buyers*
 - The Threat of Substitutes*
 - Rivalry among Existing Competitors*
 - A Sixth Force: The Strategic Role of Complements*
- 3.3 Changes over Time: Entry Choices and Industry Dynamics**
 - Entry Choices*
 - Industry Dynamics*
- 3.4 Performance Differences within the Same Industry: Strategic Groups**
 - The Strategic Group Model*
 - Mobility Barriers*
- 3.5 Implications for Strategic Leaders**

Learning Objectives

- LO 3-1** Generate a PESTEL analysis to evaluate the impact of external factors on the firm.
- LO 3-2** Differentiate the roles of firm effects and industry effects in determining firm performance.
- LO 3-3** Apply Porter's five competitive forces to explain the profit potential of different industries.
- LO 3-4** Examine how competitive industry structure shapes rivalry among competitors.
- LO 3-5** Describe the strategic role of complements in creating positive-sum co-opetition.
- LO 3-6** Explain the five choices required for market entry.
- LO 3-7** Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.
- LO 3-8** Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

Airbnb: Disrupting the Hotel Industry

IN 2007, BRIAN CHESKY

and Joe Gebbia were roommates in San Francisco. Both were industrial designers, people who shape the form and function of everything from coffee cups to office furniture to airplane interiors. But since work gigs were hit-and-miss for the aspiring industrial designers, they could not afford their rent payments. On a whim, they decided to send out

an e-mail on the distribution list for an upcoming industrial design conference in their hometown: “If you’re heading out to the [industrial design conference] in San Francisco next week and have yet to make accommodations, well, consider networking in your jam-jams. That’s right. For an affordable alternative to hotels in the city, imagine yourself in a fellow design industry person’s home, fresh awake from a snooze on the ol’ air mattress, chatting about the day’s upcoming events over Pop Tarts and OJ.”

Three people took up the offer, and the two roommates made some money to subsidize their rent payments. But more importantly, Chesky and Gebbia felt that they had stumbled upon a new business idea: Help people rent out their spare rooms. They then brought on computer scientist Nathan Blecharczyk, one of Gebbia’s former roommates, to create a website where hosts and guests could meet and transact, naming their site AirBedandBreakfast.com (later shortened to Airbnb). The three entrepreneurs tested their new site at the 2008 South by Southwest (SXSW), an annual music, film, and interactive media conference. SXSW also serves as an informal launch pad for new ventures; for example, Twitter, the social networking and news site, was unveiled at SXSW just a year earlier to great fanfare. Airbnb’s launch at SXSW flopped,

however, because the conference organizers had exclusive contracts with local hotels (a fact the Airbnb founders

only learned after the event), and so conference organizers didn’t drive any traffic to Airbnb’s site.

Not to be discouraged, Airbnb decided to take advantage of the anticipated shortage of hotel rooms in Denver, Colorado, the site of the Democratic National Convention (DNC) in the summer of 2008. After all hotels were booked, the founders prepared media releases with titles such as “Grass-

roots Housing for Grassroots Campaign,” which Obama supporters loved. As luck would have it, Airbnb was covered in both *The New York Times* and *The Wall Street Journal*. And the newly designed Airbnb site worked! It facilitated about 100 rentals during the DNC. Soon after the event, however, website traffic to Airbnb’s site fell back to zero. To keep going, Chesky and Gebbia decided to become cereal entrepreneurs, creating “Obama-O’s: The breakfast of change” and “Cap’n McCains: A maverick in every bite,” with illustrated images of the 2008 presidential candidates on 1,000 cereal boxes. After sending samples to their press contacts and subsequent coverage in the media, the limited edition cereal sold out quickly, providing enough cash to keep going with Airbnb a bit longer.

The fledgling venture’s breakthrough came in 2009 when it was accepted into a program run by Y Combinator, a start-up incubator that has spawned famous tech companies such as Dropbox, Stripe, and Twitch.tv. In exchange for equity in the new venture, these start-up accelerators provide office space, mentoring, and networking opportunities, including with venture capitalists looking to fund the next “big thing.” In 2010, Airbnb received funding from Sequoia Capital, one of the most prestigious venture capital firms in Silicon Valley, having provided early-stage capital to companies such as Apple, Google,



“Brian Chesky, Joe Gebbia, and Nathan Blecharczyk founded Airbnb on a shoestring budget in 2008. Today, Airbnb is the largest hospitality platform globally.”

©Mike Windle/Getty Images Entertainment/Getty Images

Oracle, PayPal, YouTube, and WhatsApp. Although not a first mover in the peer-to-peer rental space, Airbnb, while at Y Combinator, was the first one to figure out that a sleek website with professional photos of available rentals made all the difference. In addition, Airbnb developed a seamless transaction experience between hosts and guests, allowing it to make a bit over 10 percent on each transaction conducted on its rental site. Timing was now much more fortuitous, with the global financial crisis in full swing, people were looking for low-cost accommodations while hosts were trying to pay rent or mortgages to keep their homes.

In 2017, a mere 10 years after the two roommates had sent out the fateful e-mail inviting complete strangers to share their apartment with them, Airbnb was valued at a whopping \$31 billion! This makes Airbnb the fourth most valuable private company on the planet, just after Uber (\$6

billion); Didi Chuxing, basically China's version of Uber (\$50 billion); and Xiaomi, a Chinese smartphone maker (46 billion). Even more stunning, Airbnb's \$31 billion valuation exceeds that of Marriott, the world's largest hotel chain. And just like global hotel chains, Airbnb uses sophisticated pricing and reservation systems for guests to find, reserve, and pay for rooms to meet their various travel needs. In this sense, Airbnb is a new entrant that competes in the global hotel industry. Indeed, with more than 3 million listings in over 65,000 cities basically anywhere in the world (except North Korea), Airbnb offers more accommodations than the three biggest hotel chains combined: Marriott, Hilton, and Intercontinental.¹

You will learn more about Airbnb by reading this chapter; related questions appear in "ChapterCase3 / Consider This. . . ."



HOW CAN AN INTERNET startup based on the idea of home sharing disrupt the global hotel industry, long dominated by corporate giants such as Marriott, Hilton, or Intercontinental? One reason is that Airbnb, now the world's largest accommodation provider, owns no real estate. Instead, Airbnb uses a business model innovation to circumvent traditional entry barriers into the hotel industry. Just like Uber, Facebook, or Amazon, Airbnb provides an online platform for sellers (hosts) and buyers (renters) to connect and transact (we'll take a closer look at "Platform Strategy" in Chapter 7). While traditional hotel chains need years and millions of dollars in real estate investments to add additional capacity (finding properties, building hotels, staffing and running them, etc.), Airbnb's inventory is basically unlimited as long as it can sign up users with spare rooms to rent. Even more importantly, Airbnb does not need to deploy millions of dollars in capital to acquire and manage physical assets or manage a large cadre of employees. For example, Marriott has almost 250,000 employees, while Airbnb's headcount is some 2,500 employees (only 1 percent of Marriott's). Thus, Airbnb can grow much faster and respond much more quickly to local circumstances affecting the demand and supply of accommodations. The competitive intensity in the hotel industry is likely to increase especially in high-traffic metropolitan cities such as New York, Paris, Dubai, and Seoul.

In this chapter, we present a set of frameworks to analyze the firm's *external environment*—that is, the industry in which the firm operates, and the competitive forces that surround the firm from the outside. We move from a more macro perspective to a more micro understanding of how the external environment affects a firm's quest for competitive advantage. We begin with the PESTEL framework, which allows us to scan, monitor, and evaluate changes and trends in the firm's macroenvironment. Next, we study Porter's five forces model of competition, which helps us to determine an industry's profit potential. Depending on the firm's strategic position, these forces can affect its performance for good or ill. We also take a closer look at the choices firms must make when considering entry in an industry. We then move from a static analysis of a firm's industry environment to a dynamic understanding of how industries and competition change over time. We also discuss how to think through entry choices once an attractive industry has been identified. Next we introduce the strategic group model for understanding performance differences among clusters of firms in the same industry. Finally, we offer practical *Implications for Strategic Leaders*.

3.1 The PESTEL Framework

A firm's external environment consists of all the factors that can affect its potential to gain and sustain a competitive advantage. By analyzing the factors in the external environment, strategic leaders can mitigate threats and leverage opportunities. One common approach to understanding how external factors impinge upon a firm is to consider the source or proximity of these factors. For example, external factors in the firm's *general environment* are ones that managers have little direct influence over, such as macroeconomic factors (e.g., interest or currency exchange rates). In contrast, external factors in the firm's *task environment* are ones that managers do have some influence over, such as the composition of their strategic groups (a set of close rivals) or the structure of the industry. We will now look at each of these environmental layers in detail, moving from a firm's general environment to its task environment. Following along in Exhibit 3.1, we will be working from the outer ring to the inner ring.

The **PESTEL model** groups the factors in the firm's general environment into six segments:

- Political
- Economic
- Sociocultural
- Technological
- Ecological
- Legal

Together these form the acronym PESTEL. The PESTEL model provides a relatively straightforward way to *scan*, *monitor*, and *evaluate* the important external factors and trends that might impinge upon a firm. With more open markets and international trade in recent decades, the PESTEL factors have become more global. Such factors create both opportunities and threats.

LO 3-1

Generate a PESTEL analysis to evaluate the impact of external factors on the firm.

PESTEL model

A framework that categorizes and analyzes an important set of external factors (political, economic, sociocultural, technological, ecological, and legal) that might impinge upon a firm. These factors can create both opportunities and threats for the firm.



EXHIBIT 3.1

The Firm within Its External Environment, Industry, and Strategic Group, Subject to PESTEL Factors

POLITICAL FACTORS

Political factors result from the processes and actions of government bodies that can influence the decisions and behavior of firms.²

Although political factors are located in the firm's general environment, where firms traditionally wield little influence, companies nevertheless increasingly work to shape and influence this realm. They do so by applying *nonmarket strategies*—that is, through lobbying, public relations, contributions, litigation, and so on, in ways that are favorable to the firm.³ For example, hotel chains and resort owners have challenged Airbnb in courts and lobbied local governments, some of which passed regulations to limit or prohibit short-term rentals. Local residents in New York, San Francisco, Berlin, Paris, and many other cities are also pressuring local governments to enact more aggressive rules banning short-term rentals because they argue that companies such as Airbnb contribute to a shortage of affordable housing by turning entire apartment complexes into hotels or transforming quiet family neighborhoods into all-night, every-night party hot spots.

Political and legal factors are closely related, as political pressure often results in changes in legislation and regulation; we discuss legal factors below.

ECONOMIC FACTORS

Economic factors in a firm's external environment are largely macroeconomic, affecting economy-wide phenomena. Managers need to consider how the following five macroeconomic factors can affect firm strategy:

- Growth rates.
- Levels of employment.
- Interest rates.
- Price stability (inflation and deflation).
- Currency exchange rates.

GROWTH RATES. The overall economic *growth rate* is a measure of the change in the amount of goods and services produced by a nation's economy. Strategic leaders look to the *real growth rate*, which adjusts for inflation. This real growth rate indicates the current business cycle of the economy—that is, whether business activity is expanding or contracting. In periods of economic expansion, consumer and business demands are rising, and competition among firms frequently decreases. During economic booms, businesses expand operations to satisfy demand and are more likely to be profitable. The reverse is generally true for recessionary periods, although certain companies that focus on low-cost solutions may benefit from economic contractions because demand for their products or services rises in such times. For customers, expenditures on luxury products are often the first to be cut during recessionary periods. For instance, you might switch from a \$4 venti latte at Starbucks to a \$1 alternative from McDonald's.

Occasionally, boom periods can overheat and lead to speculative asset bubbles. In the early 2000s, the United States experienced an asset bubble in real estate.⁴ Easy credit, made possible by the availability of subprime mortgages and other financial innovations, fueled an unprecedented demand in housing. Real estate, rather than stocks, became the investment vehicle of choice for many Americans, propelled by the common belief that house prices could only go up. When the housing bubble burst, the deep economic recession of 2008–2009 began, impacting in some way nearly all businesses in the United States and worldwide.

LEVELS OF EMPLOYMENT. Growth rates directly affect the *level of employment*. In boom times, unemployment tends to be low, and skilled human capital becomes a scarce and more expensive resource. As the price of labor rises, firms have an incentive to invest more into capital goods such as cutting-edge equipment or artificial intelligence (AI).⁵ In economic downturns, unemployment rises. As more people search for employment, skilled human capital is more abundant and wages usually fall.

INTEREST RATES. Another key macroeconomic variable for managers to track is real *interest rates*—the amount that creditors are paid for use of their money and the amount that debtors pay for that use, adjusted for inflation. The economic boom during the early years in the 21st century, for example, was fueled by cheap credit. Low real interest rates have a direct bearing on consumer demand. When credit is cheap because interest rates are low, consumers buy homes, automobiles, computers, and vacations on credit; in turn, all of this demand fuels economic growth. During periods of low real interest rates, firms can easily borrow money to finance growth. Borrowing at lower real rates reduces the cost of capital and enhances a firm's competitiveness. These effects reverse, however, when real interest rates are rising. Consumer demand slows, credit is harder to come by, and firms find it more difficult to borrow money to support operations, possibly deferring investments.

PRICE STABILITY. *Price stability*—the lack of change in price levels of goods and services—is rare. Therefore, companies will often have to deal with changing price levels, which is a direct function of the amount of money in any economy. When there is too much money in an economy, we tend to see rising prices—*inflation*. Indeed, a popular economic definition of inflation is *too much money chasing too few goods and services*.⁶ Inflation tends to go with lower economic growth. Countries such as Argentina, Brazil, Mexico, and Poland experienced periods of extremely high inflation rates in recent decades.

Deflation describes a decrease in the overall price level. A sudden and pronounced drop in demand generally causes deflation, which in turn forces sellers to lower prices to motivate buyers. Because many people automatically think of lower prices from the buyer's point of view, a decreasing price level seems at first glance to be attractive. However, deflation is actually a serious threat to economic growth because it distorts expectations about the future.⁷ For example, once price levels start falling, companies will not invest in new production capacity or innovation because they expect a further decline in prices. In recent decades, the Japanese economy has been plagued with persistent deflation.

CURRENCY EXCHANGE RATES. The *currency exchange rate* determines how many dollars one must pay for a unit of foreign currency. It is a critical variable for any company that buys or sells products and services across national borders. For example, if the U.S. dollar appreciates against the euro, and so increases in real value, firms need more euros to buy one dollar. This in turn makes U.S. exports such as Boeing aircraft, Intel chips, or John Deere tractors more expensive for European buyers and reduces demand for U.S. exports overall. This process reverses when the dollar depreciates (decreases in real value) against the euro. In this scenario it would take more dollars to buy one euro, and European imports such as LVMH luxury accessories or BMW automobiles become more expensive for U.S. buyers.

In a similar fashion, if the Chinese yuan appreciates in value, Chinese goods imported into the United States are relatively more expensive. At the same time, Chinese purchasing power increases, which in turn allows their businesses to purchase more U.S. capital goods such as sophisticated machinery and other cutting-edge technologies.

In summary, economic factors affecting businesses are ever-present and rarely static. Managers need to fully appreciate the power of these factors, in both domestic and global markets, to assess their effects on firm performance.

SOCIOCULTURAL FACTORS

Sociocultural factors capture a society's cultures, norms, and values. Because sociocultural factors not only are constantly in flux but also differ across groups, strategic leaders need to closely monitor such trends and consider the implications for firm strategy. In recent years, for example, a growing number of U.S. consumers have become more health-conscious about what they eat. This trend led to a boom for businesses such as Chipotle, Subway, and Whole Foods. At the same time, traditional fast food companies McDonald's and Burger King, along with grocery chains such as Albertsons and Kroger, have all had to scramble to provide healthier choices in their product offerings.

Demographic trends are also important sociocultural factors. These trends capture population characteristics related to age, gender, family size, ethnicity, sexual orientation, religion, and socioeconomic class. Like other sociocultural factors, demographic trends present opportunities but can also pose threats. The most recent U.S. census revealed that 55 million Americans (16.4 percent of the total population) are Hispanic. It is now the largest minority group in the United States and growing fast. On average, Hispanics are also younger and their incomes are climbing quickly. This trend is not lost on companies trying to benefit from this opportunity. For example, MundoFox and ESPN Deportes (specializing in soccer) have joined Univision and NBC's Telemundo in the Spanish-language television market. In the United States, Univision is now the fifth most popular network overall, just behind the four major English-language networks (ABC, NBC, CBS, and Fox). Likewise, advertisers are pouring dollars into the Spanish-language networks to promote their products and services.⁸

TECHNOLOGICAL FACTORS

Technological factors capture the application of knowledge to create new processes and products. Major innovations in process technology include lean manufacturing, Six Sigma quality, and biotechnology. The nanotechnology revolution, which is just beginning, promises significant upheaval for a vast array of industries ranging from tiny medical devices to new-age materials for earthquake-resistant buildings.⁹ Recent product innovations include the smartphone, wearable devices such as smart watches, and high-performing electric cars such as the Tesla Model S. As discussed in the ChapterCase, Airbnb launched a radical process innovation of offering and renting rooms based on a business model leveraging the sharing economy. If one thing seems certain, technological progress is relentless and seems to be picking up speed.¹⁰ Not surprisingly, changes in the technological environment bring both opportunities and threats for companies. Given the importance of a firm's innovation strategy to competitive advantage, we discuss the effect of technological factors in greater detail in Chapter 7.

Strategy Highlight 3.1 details how BlackBerry fell victim by not paying sufficient attention to the PESTEL factors.

ECOLOGICAL FACTORS

Ecological factors involve broad environmental issues such as the natural environment, global warming, and sustainable economic growth. Organizations and the natural environment coexist in an interdependent relationship. Managing these relationships in a responsible and sustainable way directly influences the continued existence of human societies and

Strategy Highlight 3.1

BlackBerry's Bust

A pioneer in smartphones, BlackBerry was the undisputed industry leader in the early 2000s. IT managers preferred BlackBerry. Its devices allowed users to receive e-mail and other data in real time globally, with enhanced security features. For executives, a BlackBerry was not just a tool to increase productivity—and to free them from their laptops—but also an important status symbol. As a consequence, by 2008 BlackBerry's market cap had peaked at \$75 billion. Yet by 2017, this lofty valuation had fallen by almost 95 percent to a mere \$3.9 billion. What happened?

Being Canadian, Jim Balsillie, BlackBerry's longtime co-CEO, not surprisingly sees ice hockey as his favorite sport. He likes to quote Wayne Gretzky, whom many consider the best ice hockey player ever: "Skate to where the puck is going to be, not to where it is." Alas, BlackBerry did not follow that advice. BlackBerry fell victim to two important PESTEL factors in its external environment: sociocultural and technological.

Let's start with technology. The introduction of the iPhone by Apple in 2007 changed the game in the mobile device industry. Equipped with a camera, the iPhone's slick design offered a user interface with a touchscreen including a virtual keyboard. The iPhone connected seamlessly to cellular networks and Wi-Fi. Combined with thousands of apps

via the Apple iTunes store, the iPhone provided a powerful user experience, or as the late Steve Jobs said, "the internet in your pocket."

However, BlackBerry engineers and executives initially dismissed the iPhone as a mere toy with poor security features. Everyday users thought differently. They had less concern for encrypted software security than they had desire for having fun with a device that allowed them to text, surf the web, take pictures, play games, and do e-mail. Although BlackBerry devices were great in productivity applications, such as receiving and responding to e-mail via typing on its iconic physical keyboard, they provided a poor mobile web browsing experience.

The second external development that helped erode BlackBerry's dominance was sociocultural. Initially, mobile devices were issued top-down by corporate IT departments. The only available device for execs was a company-issued BlackBerry. This made life easy for IT departments ensuring network security. Consumers, however, began to bring their personal iPhones to work and used them for corporate communication and productivity applications. This bottom-up groundswell of the BYOT ("bring your own technology") movement forced corporate IT departments to open up their services beyond the BlackBerry.

Caught in the oncoming gale winds of two PESTEL factors—technological and sociocultural—BlackBerry was pushed backward in the smartphone market. Unlike Gretzky, it failed to skate where the puck was going to be and therefore continued to focus on its existing customer base of corporate IT departments and government. Later, feeble modifications in product lineup appeared to be "too little, too late." Apple continued to drive innovation in the smartphone industry by bringing out more advanced iPhone models and enhancing the usefulness of its apps for the various business and productivity applications.

Let's think about the rapid progress in mobile computing. BlackBerry, once an undisputed leader in the smartphone industry, did not recognize early enough or act upon changes in the external environment. Consumer preferences changed quickly as the iPhone and later the iPad became available. Professionals brought their own Apple or other devices to work instead of using company-issued BlackBerries. Although the Canadian technology company made a valiant effort to make up lost ground with its new BlackBerry 10 operating system and several new models, it was too little, too late.¹¹



NHL great Wayne Gretzky, shown here in 1999, his final season with the New York Rangers, holds the record for most career regular-season goals.
©AP Images/JIM ROGASH

the organizations we create. Managers can no longer separate the natural and the business worlds; they are inextricably linked.¹²

Negative examples come readily to mind, as many business organizations have contributed to the pollution of air, water, and land, as well as depletion of the world's natural resources. BP's infamous oil spill in the Gulf of Mexico destroyed fauna and flora along the U.S. shoreline from Texas to Florida. This disaster led to a decrease in fish and wildlife populations, triggered a decline in the fishery and tourism industries, and threatened the livelihood of thousands of people. It also cost BP more than \$50 billion and one-half of its market value (see Strategy Highlight 2.2).

The relationship between organizations and the natural environment need not be adversarial, however. Ecological factors can also provide business opportunities. As we saw in ChapterCase 1, Tesla is addressing environmental concerns regarding the carbon emissions of gasoline-powered cars by building zero-emission battery-powered vehicles. To generate the needed energy to charge the batteries in a sustainable way, Tesla integrated with SolarCity to provide clean-tech energy services for its customers, including decentralized solar power generation and storage via its Powerwall.

LEGAL FACTORS

Legal factors include the official outcomes of political processes as manifested in laws, mandates, regulations, and court decisions—all of which can have a direct bearing on a firm's profit potential. In fact, regulatory changes tend to affect entire industries at once. Many industries in the United States have been deregulated over the past few decades,

including airlines, telecom, energy, and trucking, among others.

As noted earlier, legal factors often coexist with or result from political will. Governments especially can directly affect firm performance by exerting both political pressure and legal sanctions, including court rulings and industry regulations. Consider how several European countries and the European Union (EU) apply political and legal pressure on U.S. tech companies. European targets include Apple, Amazon, Facebook, Google, and Microsoft—the five largest U.S. tech companies—but also startups such as Uber, the taxi-hailing mobile app. Europe's policy makers seek to retain control

over important industries ranging from transportation to the internet to ensure that profits earned in Europe by Silicon Valley firms are taxed locally. The EU parliament even proposed legislation to break up “digital monopolies” such as Google. This proposal would require Google to offer search services independently as a standalone company from its other online services, including Google Drive, a cloud-based file storage and synchronization service. But the EU wariness extends beyond tax revenue: The eurozone has much stronger legal requirements and cultural expectations concerning data privacy. Taken together, political/legal environments can have a direct bearing on a firm's performance.

Multiple PESTEL factors, for instance, are affecting the implementation of autonomous vehicles for commercial and private use. Companies such as Uber, Alphabet (through its Waymo unit), and Tesla are ready to deploy driverless cars, but political and legal factors are providing serious challenges and are delaying the widespread use of autonomous vehicles.



The Waymo driverless car, displayed during a 2016 Google event in San Francisco, marks another step in an effort to revolutionize the way people get around. Instead of driving themselves, people will be chauffeured in software-controlled vehicles if Waymo, automakers, and ride-hailing services such as Uber realize their vision.

©AP Images/Eric Risberg

3.2 Industry Structure and Firm Strategy: The Five Forces Model

INDUSTRY VS. FIRM EFFECTS IN DETERMINING FIRM PERFORMANCE

Firm performance is determined primarily by two factors: industry and firm effects. **Industry effects** describe the underlying economic structure of the industry. They attribute firm performance to the industry in which the firm competes. The structure of an industry is determined by elements common to all industries, elements such as entry and exit barriers, number and size of companies, and types of products and services offered. In a series of empirical studies, academic researchers have found that about 20 percent of a firm's profitability depends on the industry it is in.¹³ To more fully comprehend how external factors affect firm strategy and performance, we take a closer look in this chapter at an industry's underlying structure.

Firm effects attribute firm performance to the actions strategic leaders take. In Chapter 4, we look inside the firm to understand why firms within the same industry differ, and how differences among firms can lead to competitive advantage

For now, the key point is that strategic leaders' actions tend to be more important in determining firm performance than the forces exerted on the firm by its external environment.¹⁴ Empirical research studies indicate that a firm's strategy can explain up to 55 percent of its performance.¹⁵ Exhibit 3.2 shows these findings.

Although a firm's industry is not quite as important as the firm's strategy within its industry, they jointly determine roughly 75 percent of overall firm performance. The remaining 25 percent relates partly to business cycles and other effects.

We now move one step closer to the firm (in the center of Exhibit 3.1) and come to the industry in which it competes. An **industry** is a group of incumbent companies facing more or less the same set of suppliers and buyers. Firms competing in the same industry tend to offer similar products or services to meet specific customer needs. Although the PESTEL framework allows us to scan, monitor, and evaluate the external environment to identify opportunities and threats, **industry analysis** provides a more rigorous basis not only to identify an industry's profit potential—the level of profitability that can be expected for the *average* firm—but also to derive implications for one firm's strategic position within an industry. A firm's **strategic position** relates to its ability to create value for customers (V) while containing the cost to do so (C). Competitive advantage flows to

LO 3-2

Differentiate the roles of firm effects and industry effects in determining firm performance.

industry effects Firm performance attributed to the structure of the industry in which the firm competes.

firm effects Firm performance attributed to the actions managers take.

industry A group of incumbent companies that face more or less the same set of suppliers and buyers.

industry analysis A method to (1) identify an industry's profit potential and (2) derive implications for a firm's strategic position within an industry.

strategic position A firm's strategic profile based on the difference between value creation and cost ($V - C$).

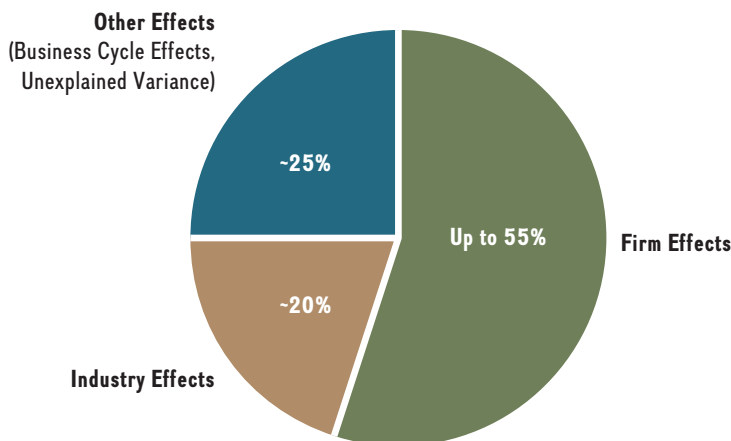


EXHIBIT 3.2

Industry, Firm, and Other Effects Explaining Superior Firm Performance

five forces model

A framework that identifies five forces that determine the profit potential of an industry and shape a firm's competitive strategy.

the firm that is able to create as large a gap as possible between the value the firm's product or service generates and the cost required to produce it ($V - C$).

Michael Porter developed the highly influential **five forces model** to help managers understand the profit potential of different industries and how they can position their respective firms to gain and sustain competitive advantage.¹⁶ By combining theory from industrial organization economics with hundreds of detailed case studies, Porter derived two key insights that form the basis of his seminal five forces model:

1. Rather than defining competition narrowly as the firm's closest competitors to explain and predict a firm's performance, competition must be viewed more broadly, to also encompass the other forces in an industry: buyers, suppliers, potential new entry of other firms, and the threat of substitutes.
2. The profit potential of an industry is neither random nor entirely determined by industry-specific factors. Rather, it is a function of the five forces that shape competition: *threat of entry, power of suppliers, power of buyers, threat of substitutes, and rivalry among existing firms.*

LO 3-3

Apply Porter's five competitive forces to explain the profit potential of different industries.

COMPETITION IN THE FIVE FORCES MODEL

Because the five forces model has especially powerful implications for strategy and competitive advantage, we will explore it in some detail. We start with the concept of competition. The first major insight this model provides is that competition involves more than just creating economic value; firms must also capture a significant share of it or they will see the economic value they create lost to suppliers, customers, or competitors. Firms create economic value by expanding as much as possible the gap between the value (V) the firm's product or service generates and the cost (C) to produce it. *Economic value* thus equals V minus C . To succeed, creating value is not enough. Firms must also be able to capture a significant share of the value created to gain and sustain a competitive advantage.

In Porter's five forces model, competition is more broadly defined beyond the firm's closest competitors (e.g., Nike versus Under Armour, The Home Depot versus Lowe's, Merck versus Pfizer, and so on) to include other industry forces: buyers, suppliers, potential new entry of other firms, and the threat of substitutes. Competition describes the struggle among these forces to capture as much of the economic value created in an industry as possible. A firm's strategic leaders, therefore, must be concerned not only with the intensity of rivalry among direct competitors, but also with the strength of the other competitive forces that are attempting to extract part or all of the economic value the firm creates. When faced with competition in this broader sense, strategy explains how a firm is able to achieve superior performance.

The second major insight from the five forces model is that it enables managers to not only understand their industry environment but also shape their firm's strategy. As a rule of thumb, *the stronger the five forces, the lower the industry's profit potential*—making the industry less attractive for competitors. The reverse is also true: *the weaker the five forces, the greater the industry's profit potential*—making the industry more attractive. Therefore, from the perspective of a strategic leader of an existing firm competing for advantage in an established industry, the company should be positioned in a way that relaxes the constraints of strong forces and leverages weak forces. The goal of crafting a strategic position is of course to improve the firm's ability to achieve and sustain a competitive advantage.

Strategy Highlight 3.2 provides an overview of the five competitive forces that shape strategy, with an application to the U.S. domestic airline industry. We will take up the topic of competitive positioning in Chapter 6 when studying business-level strategy in more detail.

Taking a closer look at the U.S. domestic airline industry in Strategy Highlight 3.2 shows how the five forces framework is a powerful and versatile tool to analyze industries.

Strategy Highlight 3.2

The Five Forces in the Airline Industry

Although many of the mega-airlines such as American, Delta, and United have lost billions of dollars over the past few decades and continue to struggle to generate consistent profitability, other players in this industry have been quite profitable because they were able to extract some of the economic value created. The airlines, however, benefited from a windfall because the prices for jet fuel fell from a high of \$3.25 per gallon (in 2011) to \$1.50 (in 2015), giving some reprieve to cash-strapped airlines. Nonetheless, competition remains intense in this industry.

Entry barriers are relatively low, resulting in a number of new airlines popping up. To enter the industry (on a small scale, serving a few select cities), a prospective new entrant needs only a couple of airplanes, which can be rented; a few pilots and crew members; some routes connecting city pairs; and gate access in airports. Indeed, despite notoriously low industry profitability, Virgin America entered the U.S. market in 2007. Virgin America is the brainchild of Sir Richard Branson, founder and chairman of the Virgin Group, a UK conglomerate of hundreds of companies using the Virgin brand, including the international airline Virgin Atlantic. Its business strategy is to offer low-cost service between major metropolitan cities on the American East and West Coasts. (In 2016, Alaska Airlines acquired Virgin America for \$2.6 billion).

To make matters worse, **substitutes** are also readily available: If prices are seen as too high, customers can drive their cars or use the train or bus. As an example, the route between Atlanta and Orlando (roughly 400 miles) used to be one of Delta's busiest and most profitable. Given the increasing security delays at airports, more and more people now prefer to drive. Taken together, the competitive forces are quite unfavorable for generating a profit potential in the

airline industry: low entry barriers, high supplier power, high buyer power combined with low customer switching costs, and the availability of low-cost substitutes. This type of hostile environment leads to intense rivalry among existing airlines and low overall industry profit potential.

In the airline industry, the **supplier power** is also strong. The providers of airframes (e.g., Boeing or Airbus), makers of aircraft engines (e.g., GE or Rolls-Royce), aircraft maintenance companies (e.g., Goodrich), caterers (e.g., Marriott), labor unions, and airports controlling gate access all bargain away the profitability of airlines. Moreover, large corporate customers can contract with airlines to serve all of their employees' travel needs; such **powerful buyers** further reduce profit margins for air carriers. To make matters worse, consumers primarily make decisions based on price.

As a consequence of these powerful industry forces, the **nature of rivalry** among airlines is incredibly intense. In inflation-adjusted dollars, ticket prices have been falling since industry deregulation in 1978. Thanks to internet travel sites such as Orbitz, Travelocity, and Kayak, price comparisons are effortless. Consumers benefit from cut-throat price competition between carriers and capture significant value. Low switching costs and nearly perfect information combine to strengthen buyer power.

The surprising conclusion is that while the mega-airlines themselves (i.e., American, Delta, and United) frequently struggle to make a profit, the other players in the industry—such as the suppliers of aircraft engines, aircraft maintenance companies, IT companies providing reservation and logistics services, caterers, airports, and so on—are quite profitable, all extracting significant value from the air transportation industry. Customers also are better off, as ticket prices have decreased and travel choices increased.¹⁷

The five forces model allows strategic leaders to analyze all players using a wider industry lens, which in turn enables a deeper understanding of an industry's profit potential. Moreover, a five forces analysis provides the basis for how a firm should position itself to gain and sustain a competitive advantage. We are now ready to look more closely at each of the five competitive forces.

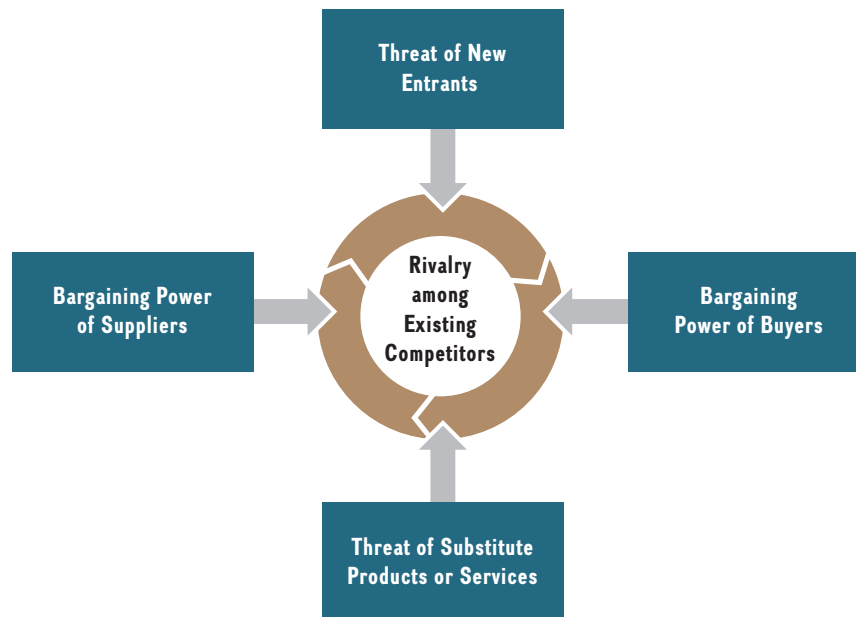
As Exhibit 3.3 shows, Porter's model identifies five key competitive forces that managers need to consider when analyzing the industry environment and formulating competitive strategy:

1. Threat of entry.
2. Power of suppliers.

EXHIBIT 3.3 /

Porter's Five Forces Model

SOURCE: Porter, M. E. (2008, Jan.). "The five competitive forces that shape strategy." *Harvard Business Review*.



3. Power of buyers.
4. Threat of substitutes.
5. Rivalry among existing competitors.

THE THREAT OF ENTRY

The **threat of entry** describes the risk that potential competitors will enter the industry. Potential new entry depresses industry profit potential in two major ways:

1. With the threat of additional capacity coming into an industry, incumbent firms may lower prices to make entry appear less attractive to the potential new competitors, which would in turn reduce the overall industry's profit potential, especially in industries with slow or no overall growth in demand. Consider the market for new microwaves. Demand consists of the replacement rate for older models and the creation of new households. Since this market grows slowly, if at all, any additional entry would likely lead to excess capacity and lower prices overall.
2. The threat of entry by additional competitors may force incumbent firms to spend more to satisfy their existing customers. This spending reduces an industry's profit potential, especially if firms can't raise prices. Consider how Starbucks has chosen to constantly upgrade and refresh its stores and service offerings. Starbucks has over 13,000 U.S. stores and more than 25,000 globally. By raising the value of its offering in the eyes of the consumers, it slows others from entering the industry or from rapidly expanding. This allows Starbucks to hold at bay smaller regional competitors, such as Peet's Coffee & Tea, with fewer than 200 stores mostly on the West Coast, and prevents smaller national chains, such as Caribou Coffee, with 415 stores nationally, from increasing the level of competition. Starbucks is willing to accept a lower profit margin to maintain its market share.

Of course, the more profitable an industry, the more attractive it is for new competitors to enter. There are, however, a number of important barriers to entry that raise the costs for potential competitors and reduce the threat of entry. **Entry barriers**, which are

threat of entry

The risk that potential competitors will enter an industry.

entry barriers

Obstacles that determine how easily a firm can enter an industry and often significantly predict industry profit potential.

advantageous for incumbent firms, are obstacles that determine how easily a firm can enter an industry. Incumbent firms can benefit from several important sources of entry barriers:

- Economies of scale.
- Network effects.
- Customer switching costs.
- Capital requirements.
- Advantages independent of size.
- Government policy.
- Credible threat of retaliation.

ECONOMIES OF SCALE. *Economies of scale* are cost advantages that accrue to firms with larger output because they can spread fixed costs over more units, employ technology more efficiently, benefit from a more specialized division of labor, and demand better terms from their suppliers. These factors in turn drive down the cost per unit, allowing large incumbent firms to enjoy a cost advantage over new entrants that cannot muster such scale.

We saw the important relationship between scale and production cost in ChapterCase 1 when featuring Tesla, a U.S. manufacturer of all-electric vehicles. Usually entrants into the broad automobile industry need large-scale production to be efficient. Tesla leveraged new technology to circumvent this entry barrier. Yet, reaching sufficient manufacturing scale to be cost-competitive is critical for Tesla as it is moving more into the mass market.

To benefit from economies of scale, Tesla is introducing new models, helping it move away from small-scale and costly production of niche vehicles to larger production runs of cars with a stronger mass-market appeal. Tesla's first vehicle, the Roadster (costing over \$110,000) was more or less a prototype to prove the viability of an all-electric car that outperforms high-performance traditional sports cars. For consumers, it created a new mind-set of what electric cars can do. Tesla ended production of the Roadster to focus more fully on its next model: the family sedan, Model S (over \$70,000). Tesla's manufacturing scale increased more than 50-fold, from some 2,500 Roadsters to 125,000 Model S's. The all-electric car company is hoping for an even broader customer appeal with its Model 3, a smaller and lower-priced vehicle (starting at \$35,000) that will allow the new company to break into the mass market and manufacture many more cars. Tesla CEO Elon Musk set an audacious goal of selling 500,000 cars a year by 2018, which is needed for the company to be profitable.¹⁸ Tesla's new product introductions over time are motivated by an attempt to capture benefits that accrue to economies of scale. To capture benefits from economies of scale including lower unit cost, Musk hopes that Tesla can increase its production volume from a mere 50,000 vehicles in 2015 to 1 million cars a year by 2020.

NETWORK EFFECTS. *Network effects* describe the positive effect that one user of a product or service has on the value of that product or service for other users. When network effects are present, the value of the product or service increases with the number of users. This is an example of a *positive externality*. The threat of potential entry is reduced when network effects are present.

For example, Facebook, with 2 billion active users worldwide, enjoys tremendous network effects, making it difficult for more recent entrants such as Google Plus to compete effectively. We will discuss network effects in more detail in Chapter 7.

network effects The value of a product or service for an individual user increases with the number of total users.



Facebook CEO Mark Zuckerberg speaks about Facebook Graph Search, introduced in 2013. Facebook's 2 billion active users reinforce its strong network effects.
©AP Images/Jeff Chiu

CUSTOMER SWITCHING COSTS. *Switching costs* are incurred by moving from one supplier to another. Changing vendors may require the buyer to alter product specifications, retrain employees, and/or modify existing processes. Switching costs are onetime sunk costs, which can be quite significant and a formidable barrier to entry. For example, a firm that has used enterprise resource planning (ERP) software from SAP for many years will incur significant switching costs when implementing a new ERP system from Oracle.

CAPITAL REQUIREMENTS. *Capital requirements* describe the “price of the entry ticket” into a new industry. How much capital is required to compete in this industry, and which companies are willing and able to make such investments? Frequently related to economies of scale, capital requirements may encompass investments to set up plants with dedicated machinery, run a production process, and cover start-up losses.

Tesla made a sizable capital investment of roughly \$150 million when it purchased the Fremont, California, manufacturing plant from Toyota and upgraded it with a highly automated production process using robots to produce cars of the highest quality at large scale.¹⁹ This strategic commitment, however, is dwarfed by the \$5 billion that Tesla is investing to build its battery “gigafactory” in Nevada.²⁰ The new factory allows Tesla to not only secure supplies of lithium-ion batteries, the most critical and expensive component of an all-electric car, but also build as many as 1 million vehicles a year.²¹ In such cases, the likelihood of entry is determined by not only the level of capital investment required to enter the industry, but also the expected return on investment. The potential new entrant must carefully weigh the required capital investments, the cost of capital, and the expected return. Taken together, the threat of entry is high when capital requirements are low in comparison to the expected returns. If an industry is attractive enough, efficient capital markets are likely to provide the necessary funding to enter an industry. Capital, unlike proprietary technology and industry-specific know-how, is a fungible resource that can be relatively easily acquired in the face of attractive returns.

ADVANTAGES INDEPENDENT OF SIZE. Incumbent firms often possess cost and quality advantages that are independent of size. These advantages can be based on brand loyalty, proprietary technology, preferential access to raw materials and distribution channels, favorable geographic locations, and cumulative learning and experience effects.

Tesla has loyal customers, which strengthens its competitive position and reduces the threat of entry into the all-electric car segment, at least by other start-up companies.²² Unlike GM or Ford, which spend billions each year on advertising, Tesla doesn’t have a large marketing budget. Rather, it relies on word of mouth. It luckily has its own “cool factor” of being different, similar to Apple in its early days. Tesla can back this perception with beautifully designed cars of top-notch quality made domestically in California. Indeed, when *Consumer Reports* tested the Model S, the usually understated magazine concluded: “The Tesla Model S is the best car we ever tested.”²³ In addition, many Tesla owners feel an emotional connection to the company because they deeply believe in the company’s vision “to accelerate the world’s transition to sustainable energy.”

Preferential access to raw materials and key components can bestow absolute cost advantages. As mentioned, lithium-ion batteries are not only the most expensive and critical parts of an all-electric vehicle, but they are also in short supply. Tesla’s new battery “gigafactory” will afford it independence from the few worldwide suppliers, such as Panasonic of Japan, and also likely bestow an absolute cost advantage.²⁴ This should further reduce the threat of new entry in the all-electric vehicle segment, assuming no radical technological changes are to be expected in battery-cell technology in the next few years.

Favorable locations, such as Silicon Valley for Tesla, often present advantages that other locales cannot match easily, including access to human and venture capital, and world-class research and engineering institutions.

Finally, incumbent firms often benefit from cumulative learning and experience effects accrued over long periods of time. Tesla now has more than 10 years of experience in designing and building high-performance all-electric vehicles of superior quality and design. Attempting to obtain such deep knowledge within a shorter time frame is often costly, if not impossible, which in turn constitutes a formidable barrier to entry.

GOVERNMENT POLICY. Frequently government policies restrict or prevent new entrants. Until recently, India did not allow foreign retailers such as Walmart or IKEA to own stores and compete with domestic companies in order to protect the country's millions of small vendors and wholesalers. China frequently requires foreign companies to enter joint ventures with domestic ones and to share technology.

In contrast, deregulation in industries such as airlines, telecommunications, and trucking have generated significant new entries. Therefore, the threat of entry is high when restrictive government policies do not exist or when industries become deregulated.

CREDIBLE THREAT OF RETALIATION. Potential new entrants must also anticipate how incumbent firms will react. A credible threat of retaliation by incumbent firms often deters entry. Should entry still occur, however, incumbents are able to retaliate quickly, through initiating a price war, for example. The industry profit potential can in this case easily fall below the cost of capital. Incumbents with deeper pockets than new entrants are able to withstand price competition for a longer time and wait for the new entrants to exit the industry—then raise prices again. Other weapons of retaliation include increased product and service innovation, advertising, sales promotions, and litigation.

Potential new entrants should expect a strong and vigorous response beyond price competition by incumbent firms in several scenarios. If the current competitors have deep pockets, unused excess capacity, reputational clout with industry suppliers and buyers, a history of vigorous retaliation during earlier entry attempts, or heavy investments in resources specific to the core industry and ill-suited for adaptive use, then they are likely to press these advantages. Moreover, if industry growth is slow or stagnant, incumbents are more likely to retaliate against new entrants to protect their market share, often initiating a price war with the goal of driving out these new entrants.

In contrast, the threat of entry is high when new entrants expect that incumbents will not or cannot retaliate. For example, in the southeastern United States, TV cable company Comcast has entered the market for residential and commercial telephone services and internet connectivity (as an ISP, internet service provider), emerging as a direct competitor for AT&T. Comcast also acquired NBC Universal, combining delivery and content. AT&T responded to Comcast's threat by introducing U-verse, a product combining high-speed internet access with cable TV and telephone service, all provided over its fast fiber-optic network.

THE POWER OF SUPPLIERS

The bargaining power of suppliers captures pressures that industry suppliers can exert on an industry's profit potential. This force reduces a firm's ability to obtain superior performance for two reasons: Powerful suppliers can raise the cost of production by demanding higher prices for their inputs or by reducing the quality of the input factor or service level delivered. Powerful suppliers are a threat to firms because they reduce the industry's profit potential by capturing part of the economic value created.

To compete effectively, companies generally need a wide variety of inputs into the production process, including raw materials and components, labor (via individuals or labor unions, when the industry faces collective bargaining), and services. The relative bargaining power of suppliers is high when

- The supplier's industry is more concentrated than the industry it sells to.
- Suppliers do not depend heavily on the industry for a large portion of their revenues.
- Incumbent firms face significant switching costs when changing suppliers.
- Suppliers offer products that are differentiated.
- There are no readily available substitutes for the products or services that the suppliers offer.
- Suppliers can credibly threaten to forward-integrate into the industry.

In Strategy Highlight 3.2, we noted that the airline industry faces strong supplier power. Let's take a closer look at one important supplier group to this industry: Boeing and Airbus, the makers of large commercial jets. The reason airframe manufacturers are powerful suppliers to airlines is because their industry is much more concentrated (only two firms) than the industry it sells to. Compared to two airframe suppliers, there are hundreds of commercial airlines around the world. Given the trend of large airlines merging to create even larger mega-airlines, however, increasing buyer power may eventually balance this out a bit. Nonetheless, the airlines face nontrivial switching costs when changing suppliers because pilots and crew would need to be retrained to fly a new type of aircraft, maintenance capabilities would need to be expanded, and some routes may even need to be reconfigured due to differences in aircraft range and passenger capacity. Moreover, while some of the aircraft can be used as substitutes, Boeing and Airbus offer differentiated products. This fact becomes clearer when considering the most recent models from each company. Boeing introduced the 787 Dreamliner to capture long-distance point-to-point travel (close to an 8,000-mile range, sufficient to fly nonstop from Los Angeles to Sydney), while Airbus introduced the A-380 Superjumbo to focus on high-volume transportation (close to 900 passengers) between major airport hubs (e.g., Tokyo's Haneda Airport and Singapore's Changi International Airport). When considering long-distance travel, there are no readily available substitutes for commercial airliners, a fact that strengthens supplier power.

All in all, the vast strengths of these factors lead us to conclude that the supplier power of commercial aircraft manufacturers is quite significant. This puts Boeing and Airbus in a strong position to extract profits from the airline industry, thus reducing the profit potential of the airlines themselves.

Although the supplier power of Boeing and Airbus is strong, several factors moderate their bargaining positions somewhat. First, the suppliers of commercial airliners depend heavily on commercial airlines for their revenues. Second, Boeing and Airbus are unlikely to threaten forward integration and become commercial airlines themselves. Third, Bombardier of Canada and Embraer of Brazil, both manufacturers of smaller commercial airframes, have begun to increase the size of the jets they offer and thus now compete with some of the smaller planes such as Boeings 737 and Airbus A-320. Finally, industry structures are not static, but can change over time. In the past few years, several of the remaining large domestic U.S. airlines have merged (Delta and Northwest, United and Continental, and American and U.S. Airways), which changed the industry structure in their favor. There are now fewer but even larger airlines remaining. This fact increases their buyer power, which we turn to next.

THE POWER OF BUYERS

In many ways, the bargaining power of buyers is the flip side of the bargaining power of suppliers. Buyers are the customers of an industry. The power of buyers concerns the

pressure an industry's customers can put on the producers' margins in the industry by demanding a lower price or higher product quality. When buyers successfully obtain price discounts, it reduces a firm's top line (revenue). When buyers demand higher quality and more service, it generally raises production costs. Strong buyers can therefore reduce industry profit potential and a firm's profitability. Powerful buyers are a threat to the producing firms because they reduce the industry's profit potential by capturing part of the economic value created.

As with suppliers, an industry may face many different types of buyers. The buyers of an industry's product or service may be individual consumers—like you or me when we decide which provider we want to use for our wireless devices. In many areas, you can choose between several providers such as AT&T, Sprint, T-Mobile, or Verizon. Although we might be able to find a good deal when carefully comparing their individual service plans, as individual consumers we generally do not have significant buyer power. On the other hand, large institutions such as businesses or universities have significant buyer power when deciding which provider to use for their wireless services, because they are able to sign up or move several thousand employees at once.

The power of buyers is high when

- There are a few buyers and each buyer purchases large quantities relative to the size of a single seller.
- The industry's products are standardized or undifferentiated commodities.
- Buyers face low or no switching costs.
- Buyers can credibly threaten to backwardly integrate into the industry.

In addition, companies need to be aware of situations when buyers are especially price sensitive. This is the case when

- The buyer's purchase represents a significant fraction of its cost structure or procurement budget.
- Buyers earn low profits or are strapped for cash.
- The quality (cost) of the buyers' products and services is not affected much by the quality (cost) of their inputs.

The retail giant Walmart provides perhaps the most potent example of tremendous buyer power. Walmart is not only the largest retailer worldwide (with 12,000 stores and over 2 million employees), but it is also one of the largest companies in the world (with some \$500 billion in revenues in 2017). Walmart is one of the few large big-box global retail chains and frequently purchases large quantities from its suppliers. Walmart leverages its buyer power by exerting tremendous pressure on its suppliers to lower prices and to increase quality or risk losing access to shelf space at the largest retailer in the world. Walmart's buyer power is so strong that many suppliers co-locate offices next to Walmart's headquarters in Bentonville, Arkansas, because such proximity enables Walmart's managers to test the suppliers' latest products and negotiate prices.

The bargaining power of buyers also increases when their switching costs are low. Having multiple suppliers of a product category located close to its headquarters allows Walmart to demand further price cuts and quality improvements because it can easily switch from one supplier to the next. This threat is even more pronounced if the products are non-differentiated commodities from the consumer's perspective. For example, Walmart can easily switch from Rubbermaid plastic containers to Sterilite containers by offering more shelf space to the producer that offers the greatest price cut or quality improvement.



Buyers are also powerful when they can credibly threaten backward integration. Backward integration occurs when a buyer moves upstream in the industry value chain, into the seller's business. Walmart has exercised the threat to backward-integrate by producing a number of products as private-label brands such as Equate health and beauty items, Ol'Roy dog food, and Parent's Choice baby products. Taken together, powerful buyers have the ability to extract a significant amount of the value created in the industry, leaving little or nothing for producers.

In regard to any of the five forces that shape competition, it is important to note that their relative strengths are context-dependent. For example, the Mexican multinational CEMEX, one of the world's leading cement producers, faces very different buyer power in the United States than domestically. In the United States, cement buyers consist of a few large and powerful construction companies that account for a significant percentage of CEMEX's output. The result? Razor-thin margins. In contrast, the vast majority of CEMEX customers in its Mexican home market are numerous, small, individual customers facing a few large suppliers, with CEMEX being the biggest. CEMEX earns high profit margins in its home market. With the same undifferentiated product, CEMEX competes in two different industry scenarios in terms of buyer strength.

THE THREAT OF SUBSTITUTES

Substitutes meet the same basic customer needs as the industry's product but in a different way. The threat of substitutes is the idea that products or services available from *outside the given industry* will come close to meeting the needs of current customers.²⁵ For example, many software products are substitutes to professional services, at least at the lower end. Tax preparation software such as Intuit's TurboTax is a substitute for professional services offered by H&R Block and others. LegalZoom, an online legal documentation service, is a threat to professional law firms. Other examples of substitutes are energy drinks versus coffee, videoconferencing versus business travel, e-mail versus express mail, gasoline versus biofuel, and wireless telephone services versus Voice over Internet Protocol (VoIP), offered by Skype or now many apps such as Facebook's WhatsApp or Tencent's WeChat.

A high threat of substitutes reduces industry profit potential by limiting the price the industry's competitors can charge for their products and services. The threat of substitutes is high when:

- The substitute offers an attractive price-performance trade-off.
- The buyers cost of switching to the substitute is low.

The movie rental company Redbox, which uses 44,000 kiosks in the United States to make movie rentals available for just \$2, is a substitute for buying movie DVDs. For buyers, video rental via Redbox offers an attractive price-performance trade-off with low switching costs in comparison to DVD ownership. Moreover, for customers that view only a few movies a month, Redbox is also a substitute for Netflix's on-demand internet movie streaming service, which costs \$9.99 a month. Rather than a substitute, however, Redbox is a direct competitor to Netflix's DVD rental business, where plans cost \$7.99 a month (for one DVD out at a time).

In addition to a lower price, substitutes may also become more attractive by offering a higher value proposition.²⁶ In Spain, some 6 million people travel annually between Madrid and Barcelona, roughly 400 miles apart. The trip by car or train takes most of the day, and 90 percent of travelers would choose to fly, creating a highly profitable business for local airlines. This all changed when the Alta Velocidad Española (AVE), an ultra-modern high-speed train, was completed in 2008. Taking into account total time involved,

high-speed trains are faster than short-haul flights. Passengers travel in greater comfort than airline passengers and commute from one city center to the next, with only a short walk or cab ride to their final destinations.

The AVE example highlights the two fundamental insights provided by Porter's five forces framework. First, competition must be defined more broadly to go beyond direct industry competitors. In this case, rather than defining competition narrowly as the firm's closest competitors, airline executives in Spain must look beyond other airlines and consider substitute offerings such as high-speed trains. Second, any of the five forces on its own, if sufficiently strong, can extract industry profitability. In the AVE example, the threat of substitutes is limiting the airline industry's profit potential. With the arrival of the AVE, the airlines' monopoly on fast transportation between Madrid and Barcelona vanished, and with it the airlines' high profits. The strong threat of substitutes in this case increased the rivalry among existing competitors in the Spanish air transportation industry.

RIVALRY AMONG EXISTING COMPETITORS

Rivalry among existing competitors describes the intensity with which companies within the same industry jockey for market share and profitability. It can range from genteel to cut-throat. The other four forces—threat of entry, the power of buyers and suppliers, and the threat of substitutes—all exert pressure upon this rivalry, as indicated by the arrows pointing toward the center in Exhibit 3.3. The stronger the forces, the stronger the expected competitive intensity, which in turn limits the industry's profit potential.

Competitors can lower prices to attract customers from rivals. When intense rivalry among existing competitors brings about price discounting, industry profitability erodes. Alternatively, competitors can use non-price competition to create more value in terms of product features and design, quality, promotional spending, and after-sales service and support. When non-price competition is the primary basis of competition, costs increase, which can also have a negative impact on industry profitability. However, when these moves create unique products with features tailored closely to meet customer needs and willingness to pay, then average industry profitability tends to increase because producers are able to raise prices and thus increase revenues and profit margins.

The intensity of rivalry among existing competitors is determined largely by the following factors:

- Competitive industry structure.
- Industry growth.
- Strategic commitments.
- Exit barriers.

COMPETITIVE INDUSTRY STRUCTURE. The **competitive industry structure** refers to elements and features common to all industries. The structure of an industry is largely captured by

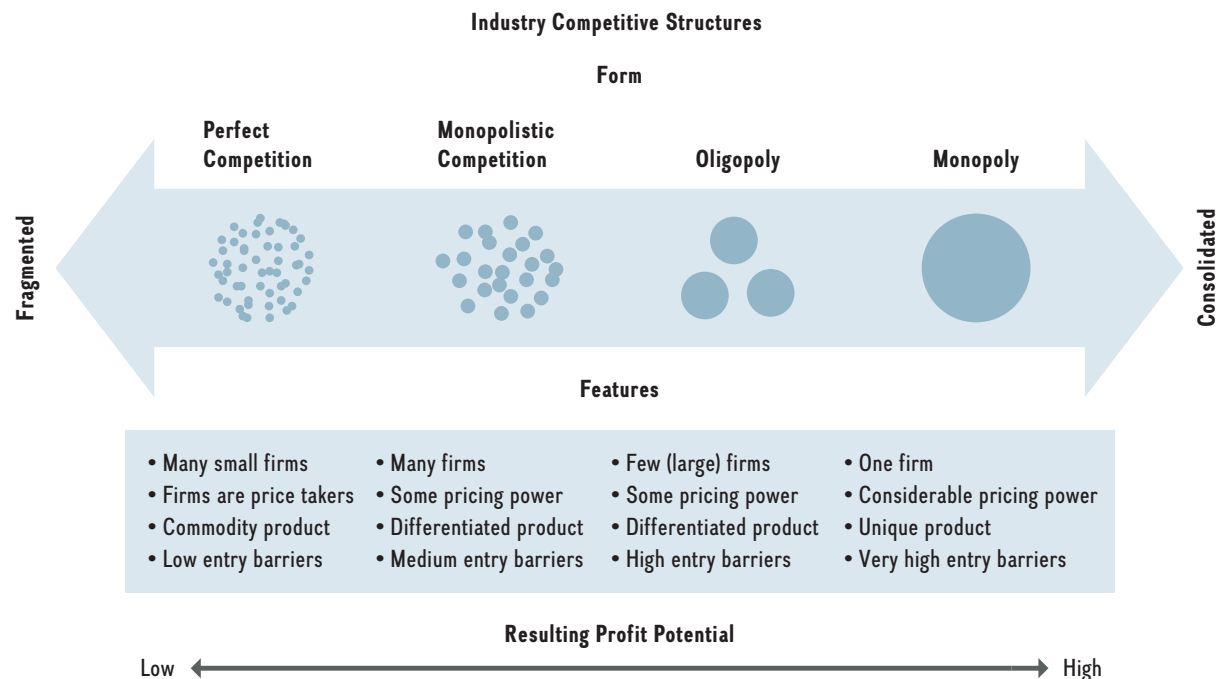
- The number and size of its competitors.
- The firm's degree of pricing power.
- The type of product or service (commodity or differentiated product).
- The height of entry barriers.²⁷

Exhibit 3.4 shows different industry types along a continuum from fragmented to consolidated structures. At one extreme, a *fragmented industry* consists of many small firms and tends to generate low profitability. At the other end of the continuum, a *consolidated*

LO 3-4

Examine how competitive industry structure shapes rivalry among competitors.

competitive industry structure Elements and features common to all industries, including the number and size of competitors, the firms' degree of pricing power, the type of product or service offered, and the height of entry barriers.

EXHIBIT 3.4 / Industry Competitive Structures along the Continuum from Fragmented to Consolidated

industry is dominated by a few firms, or even just one firm, and has the potential to be highly profitable. The four main competitive industry structures are:

1. Perfect competition
2. Monopolistic competition
3. Oligopoly
4. Monopoly

Perfect Competition. A *perfectly competitive* industry is fragmented and has many small firms, a commodity product, ease of entry, and little or no ability for each individual firm to raise its prices. The firms competing in this type of industry are approximately similar in size and resources. Consumers make purchasing decisions solely on price, because the commodity product offerings are more or less identical. The resulting performance of the industry shows low profitability. Under these conditions, firms in perfect competition have difficulty achieving even a temporary competitive advantage and can achieve only competitive parity. Although perfect competition is a rare industry structure in its pure form, markets for commodities such as natural gas, copper, and iron tend to approach this structure.

Modern high-tech industries are also not immune to the perils of perfect competition. Many internet entrepreneurs learned the hard way that it is difficult to beat the forces of perfect competition. Fueled by eager venture capitalists, about 100 online pet supply stores such as *pets.com*, *petopia.com*, and *pet-store.com* had sprung up by 1999, at the height of the internet bubble.²⁸ Cut-throat competition ensued, with online retailers selling products below cost. When many small firms are offering a commodity product in an industry that is easy to enter, no one is able to increase prices and generate profits. To make matters worse, at the same time, category-killers such as PetSmart and PetCo were expanding rapidly, opening some 2,000 brick-and-mortar stores in the United States and Canada. The

ensuing price competition led to an industry shakeout, leaving online retailers in the dust. Looking at the competitive industry structures depicted in Exhibit 3.4, we might have predicted that online pet supply stores were unlikely to be profitable.

Monopolistic Competition. A *monopolistically competitive* industry has many firms, a differentiated product, some obstacles to entry, and the ability to raise prices for a relatively unique product while retaining customers. The key to understanding this industry structure is that the firms now offer products or services with unique features.

The computer hardware industry provides one example of monopolistic competition. Many firms compete in this industry, and even the largest of them (Apple, ASUS, Dell, HP, or Lenovo) have less than 20 percent market share. Moreover, while products between competitors tend to be similar, they are by no means identical. As a consequence, firms selling a product with unique features tend to have some ability to raise prices. When a firm is able to differentiate its product or service offerings, it carves out a niche in the market in which it has some degree of monopoly power over pricing, thus the name “monopolistic competition.” Firms frequently communicate the degree of product differentiation through advertising.

Oligopoly. An *oligopolistic* industry is consolidated with a few large firms, differentiated products, high barriers to entry, and some degree of pricing power. The degree of pricing power depends, just as in monopolistic competition, on the degree of product differentiation.

A key feature of an oligopoly is that the competing firms are *interdependent*. With only a few competitors in the mix, the actions of one firm influence the behaviors of the others. Each competitor in an oligopoly, therefore, must consider the strategic actions of the other competitors. This type of industry structure is often analyzed using *game theory*, which attempts to predict strategic behaviors by assuming that the moves and reactions of competitors can be anticipated.²⁹ Due to their strategic interdependence, companies in oligopolies have an incentive to coordinate their strategic actions to maximize joint performance. Although explicit coordination such as price fixing is illegal in the United States, tacit coordination such as “an unspoken understanding” is not.

The express-delivery industry is an example of an oligopoly. The main competitors in this space are FedEx and UPS. Any strategic decision made by FedEx (e.g., to expand delivery services to ground delivery of larger-size packages) directly affects UPS; likewise, any decision made by UPS (e.g., to guarantee next-day delivery before 8:00 a.m.) directly affects FedEx. Other examples of oligopolies include the soft drink industry (Coca-Cola versus Pepsi), airframe manufacturing business (Boeing versus Airbus), home-improvement retailing (The Home Depot versus Lowe’s), toys and games (Hasbro versus Mattel), and detergents (P&G versus Unilever).³⁰

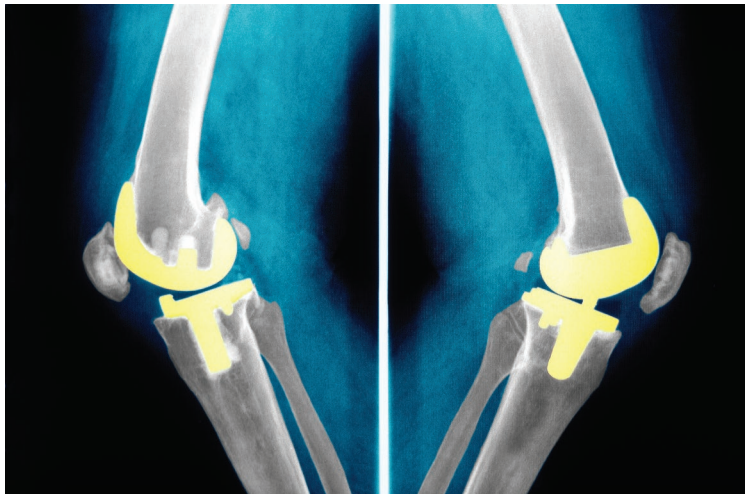
Companies in an oligopoly tend to have some pricing power if they are able to differentiate their product or service offerings from those of their competitors. *Non-price competition*, therefore, is the preferred mode of competition. This means competing by offering unique product features or services rather than competing based on price alone. When one firm in an oligopoly cuts prices to gain market share from its competitor, the competitor typically will respond in kind and also cut prices. This process initiates a price war, which can be especially detrimental to firm performance if the products are close rivals.

In the early years of the soft drink industry, for example, whenever PepsiCo lowered prices, Coca-Cola followed suit. These actions only resulted in reduced profitability for both companies. In recent decades, both Coca-Cola and PepsiCo have repeatedly demonstrated that they have learned this lesson. They shifted the basis of competition from price-cutting to new product introductions and lifestyle advertising. Any price adjustments are merely short-term promotions. By leveraging innovation and advertising, Coca-Cola and PepsiCo have moved to non-price competition, which in turn allows them to charge higher prices and to improve industry and company profitability.³¹

Monopoly. An industry is a *monopoly* when there is only one, often large firm supplying the market. The firm may offer a unique product, and the challenges to moving into the industry tend to be high. The monopolist has considerable pricing power. As a consequence, firm and thus industry profit tends to be high. The one firm is the industry.

In some instances, the government will grant one firm the right to be the sole supplier of a product or service. This is often done to incentivize a company to engage in a venture that would not be profitable if there was more than one supplier. For instance, public utilities incur huge fixed costs to build plants and to supply a certain geographic area. Public utilities supplying water, gas, and electricity to businesses and homes are frequently monopolists. As examples, Georgia Power is the only supplier of electricity for some 2.5 million customers in the southeastern United States. Philadelphia Gas Works is the only supplier of natural gas in the city of Philadelphia, Pennsylvania, serving some 500,000 customers. These are so-called *natural monopolies*. Without them, the governments involved believe the market would not supply these products or services. In the past few decades, however, more and more of these natural monopolies have been deregulated in the United States, including airlines, telecommunications, railroads, trucking, and ocean transportation. This deregulation has allowed competition to emerge, which frequently leads to lower prices, better service, and more innovation.

While natural monopolies appear to be disappearing from the competitive landscape, so-called *near monopolies* are of much greater interest to strategists. These are firms that have accrued significant market power, for example, by owning valuable patents or proprietary technology. In the process, they are changing the industry structure in their favor, generally from monopolistic competition or oligopolies to near monopolies. These near monopolies are firms that have accomplished product differentiation to such a degree that they are in a class by themselves, just like a monopolist. The European Union, for example, views Google with its 90 percent market share in online search as a “digital monopoly.”³² This is an enviable position in terms of the ability to extract profits by leveraging its data to provide targeted online advertising and other customized services, so long as Google can steer clear of monopolistic behavior, which may attract antitrust regulators and lead to legal repercussions.



The prosthetic for knee replacement is a fast-growing market segment in the medical products industry.

©BSIP/Getty Images

INDUSTRY GROWTH. Industry growth directly affects the intensity of rivalry among competitors. In periods of high growth, consumer demand rises, and price competition among firms frequently decreases. Because the pie is expanding, rivals are focused on capturing part of that larger pie rather than taking market share and profitability away from one another. The demand for knee replacements, for example, is a fast-growing segment in the medical products industry. In the United States, robust demand is driven by the need for knee replacements for an aging population as well as for an increasingly obese population.

The leading competitors are Zimmer Biomet, DePuy, and Stryker, with significant share held by Smith & Nephew. Competition is primarily based on innovative design, improved implant materials, and differentiated products such as gender solutions and a range of high-flex knees. With improvements to materials and procedures, younger patients are also increasingly choosing early surgical

intervention. Competitors are able to avoid price competition and, instead, focus on differentiation that allows premium pricing.

In contrast, rivalry among competitors becomes fierce during slow or even negative industry growth. Price discounts, frequent new product releases with minor modifications, intense promotional campaigns, and fast retaliation by rivals are all tactics indicative of an industry with slow or negative growth. Competition is fierce because rivals can gain only at the expense of others; therefore, companies are focused on taking business away from one another. Demand for traditional fast food providers such as McDonald's, Burger King, and Wendy's has been declining in recent years. Consumers have become more health-conscious and demand has shifted to alternative restaurants such as Subway, Chick-fil-A, and Chipotle. Attempts by McDonald's, Burger King, and Wendy's to steal customers from one another include frequent discounting tactics such as dollar menus. Such competitive tactics are indicative of cut-throat competition and a low profit potential in the traditional hamburger fast food industry.

Competitive rivalry based solely on cutting prices is especially destructive to profitability because it transfers most, if not all, of the value created in the industry to the customers—leaving little, if anything, for the firms in the industry. While this may appear attractive to customers, firms that are not profitable are not able to make the investments necessary to upgrade their product offerings or services to provide higher value, and they eventually leave the industry. Destructive price competition can lead to limited choices, lower product quality, and higher prices for consumers in the long run if only a few large firms survive.

STRATEGIC COMMITMENTS. If firms make strategic commitments to compete in an industry, rivalry among competitors is likely to be more intense. **Strategic commitments** are firm actions that are costly, long-term oriented, and difficult to reverse. Strategic commitments to a specific industry can stem from large, fixed cost requirements, but also from noneconomic considerations.³³

For example, significant strategic commitments are required to compete in the airline industry when using a hub-and-spoke system to provide not only domestic but also international coverage. U.S. airlines Delta, United, and American have large fixed costs to maintain their network of routes that affords global coverage, frequently in conjunction with foreign partner airlines. These fixed costs in terms of aircraft, gate leases, hangars, maintenance facilities, baggage facilities, and ground transportation all accrue before the airlines sell any tickets. High fixed costs create tremendous pressure to fill empty seats. An airline seat on a specific flight is perishable, just like hotel rooms not filled. Empty airline seats are often filled through price-cutting. Given similar high fixed costs, other airlines respond in kind. Eventually, a vicious cycle of price-cutting ensues, driving average industry profitability to zero, or even negative numbers (where the companies are losing money). To make matters worse, given their strategic commitments, airlines are unlikely to exit an industry. Excess capacity remains, further depressing industry profitability.

In other cases, strategic commitments to a specific industry may be the result of more political than economic considerations. Airbus, for example, was created by a number of European governments through direct subsidies to provide a countervailing power to Boeing. The European Union in turn claims that Boeing is subsidized by the U.S. government indirectly via defense contracts. Given these political considerations and large-scale strategic commitments, neither Airbus nor Boeing is likely to exit the aircraft manufacturing industry even if industry profit potential falls to zero.

EXIT BARRIERS. The rivalry among existing competitors is also a function of an industry's **exit barriers**, the obstacles that determine how easily a firm can leave that industry. Exit barriers

strategic commitments
Firm actions that are costly, long-term oriented, and difficult to reverse.

exit barriers Obstacles that determine how easily a firm can leave an industry.

comprise both economic and social factors. They include fixed costs that must be paid regardless of whether the company is operating in the industry or not. A company exiting an industry may still have contractual obligations to suppliers, such as employee health care, retirement benefits, and severance pay. Social factors include elements such as emotional attachments to certain geographic locations. In Michigan, entire communities still depend on GM, Ford, and Chrysler. If any of those carmakers were to exit the industry, communities would suffer. Other social and economic factors include ripple effects through the supply chain. When one major player in an industry shuts down, its suppliers are adversely impacted as well.

An industry with low exit barriers is more attractive because it allows underperforming firms to exit more easily. Such exits reduce competitive pressure on the remaining firms because excess capacity is removed. In contrast, an industry with high exit barriers reduces its profit potential because excess capacity still remains. All of the large airlines featured in Strategy Highlight 3.2 (American, Delta, and United) have filed for bankruptcy at one point. Due to a unique feature of U.S. Chapter 11 bankruptcy law, however, companies may continue to operate and reorganize while being temporarily shielded from their creditors and other obligations until renegotiated. This implies that excess capacity is not removed from the industry, and by putting pressure on prices further reduces industry profit potential.

To summarize our discussion of the five forces model, Exhibit 3.5 provides a checklist that you can apply to any industry when assessing the underlying competitive forces that shape strategy. The key take-away from the five forces model is that the stronger the forces, the lower the industry's ability to earn above-average profits, and correspondingly, the lower the firm's ability to gain and sustain a competitive advantage. Conversely, the weaker the forces, the greater the industry's ability to earn above-average profits, and correspondingly, the greater the firm's ability to gain and sustain competitive advantage. Therefore, managers need to craft a strategic position for their company that leverages weak forces into opportunities and mitigates strong forces because they are potential threats to the firm's ability to gain and sustain a competitive advantage.

complement A product, service, or competency that adds value to the original product offering when the two are used in tandem.

LO 3-5

Describe the strategic role of complements in creating positive-sum co-opetition.

complementor A company that provides a good or service that leads customers to value your firm's offering more when the two are combined.

co-opetition Cooperation by competitors to achieve a strategic objective.

A SIXTH FORCE: THE STRATEGIC ROLE OF COMPLEMENTS

As valuable as the five forces model is for explaining the profit potential and attractiveness of industries, the value of Porter's five forces model can be further enhanced if one also considers the availability of complements.³⁴

A **complement** is a product, service, or competency that adds value to the original product offering when the two are used in tandem.³⁵ Complements increase demand for the primary product, thereby enhancing the profit potential for the industry and the firm. A company is a **complementor** to your company if customers value your product or service offering more when they are able to combine it with the other company's product or service.³⁶ Firms may choose to provide the complements themselves or work with another company to accomplish this.

For example, in the smartphone industry, Alphabet's Google complements Samsung. The Korean high-tech company's smartphones are more valuable when they come with Google's Android system installed. At the same time, Google and Samsung are increasingly becoming competitors. With Google's acquisition of Motorola Mobility, the online search company launched its own line of smartphones and Chromebooks. This development illustrates the process of **co-opetition**, which is cooperation by competitors to achieve a strategic objective. Samsung and Google cooperate as complementors to compete against Apple's strong position in the mobile device industry, while at the same time Samsung and Google are increasingly becoming competitive with one another. While Google retained Motorola's patents to use for development in its future phones, and to defend itself against competitors such as Samsung and Apple, Alphabet (Google's parent company) sold the manufacturing arm of Motorola to Lenovo, a Chinese maker of computers and mobile devices.

The threat of entry is high when:

- ✓ The minimum efficient scale to compete in an industry is low.
- ✓ Network effects are not present.
- ✓ Customer switching costs are low.
- ✓ Capital requirements are low.
- ✓ Incumbents do not possess:
 - Brand loyalty.
 - Proprietary technology.
 - Preferential access to raw materials.
 - Preferential access to distribution channels.
 - Favorable geographic locations.
 - Cumulative learning and experience effects.
- ✓ Restrictive government regulations do not exist.
- ✓ New entrants expect that incumbents will not or cannot retaliate.

The power of suppliers is high when:

- ✓ Supplier's industry is more concentrated than the industry it sells to.
- ✓ Suppliers do not depend heavily on the industry for their revenues.
- ✓ Incumbent firms face significant switching costs when changing suppliers.
- ✓ Suppliers offer products that are differentiated.
- ✓ There are no readily available substitutes for the products or services that the suppliers offer.
- ✓ Suppliers can credibly threaten to forward-integrate into the industry.

The power of buyers is high when:

- ✓ There are a few buyers and each buyer purchases large quantities relative to the size of a single seller.
- ✓ The industry's products are standardized or undifferentiated commodities.
- ✓ Buyers face low or no switching costs.
- ✓ Buyers can credibly threaten to backwardly integrate into the industry.

The threat of substitutes is high when:

- ✓ The substitute offers an attractive price-performance trade-off.
- ✓ The buyer's cost of switching to the substitute is low.

The rivalry among existing competitors is high when:

- ✓ There are many competitors in the industry.
- ✓ The competitors are roughly of equal size.
- ✓ Industry growth is slow, zero, or even negative.
- ✓ Exit barriers are high.
- ✓ Incumbent firms are highly committed to the business.
- ✓ Incumbent firms cannot read or understand each other's strategies well.
- ✓ Products and services are direct substitutes.
- ✓ Fixed costs are high and marginal costs are low.
- ✓ Excess capacity exists in the industry.
- ✓ The product or service is perishable.

EXHIBIT 3.5 /**The Five Forces
Competitive Analysis
Checklist**

SOURCE: Adapted from M.E. Porter (2008), "The five competitive forces that shape strategy," *Harvard Business Review*, January.

In 2017, Google acquired HTC's smartphone engineering group for \$1.1 billion. The Taiwanese smartphone maker developed the Google Pixel phone. With this acquisition, Google is making a commitment to handset manufacturing, unlike in the Motorola deal which was more motivated by intellectual property considerations. Integrating HTC's smartphone unit within Google will allow engineers to more tightly integrate hardware and software. This in turn will allow Google to differentiate its high-end Pixel phone more from the competition, especially Apple's newly released iPhone X and Samsung's Galaxy 8 line of phone, including the Note 8.

LO 3-6

Explain the five choices required for market entry.

3.3 Changes over Time: Entry Choices and Industry Dynamics

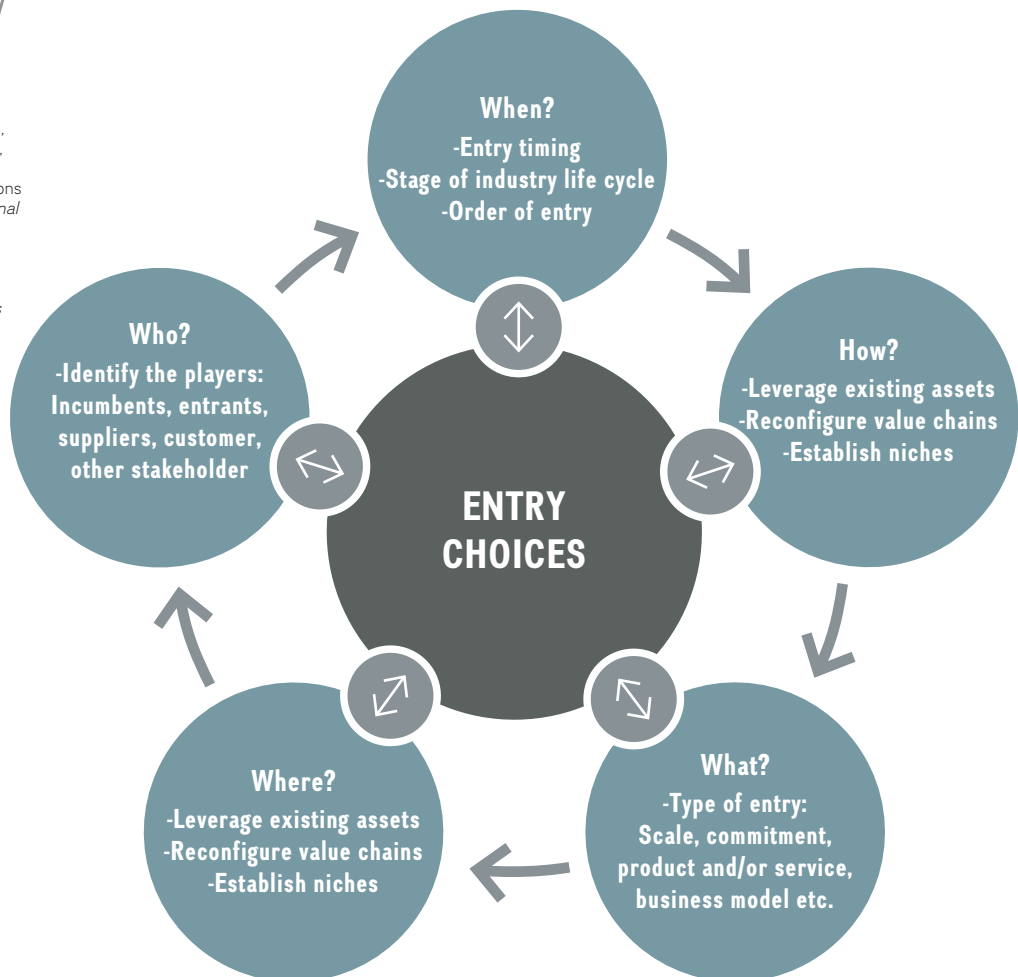
ENTRY CHOICES

One of the key insights of the five forces model is that the more profitable an industry, the more attractive it becomes to competitors. Let's assume a firm's strategic leaders are aware of potential barriers to entry (discussed above), but would nonetheless like to contemplate potential market entry because the industry profitability is high and thus quite attractive. Exhibit 3.6 shows an integrative model that can guide the entry choices firms make.

EXHIBIT 3.6 /

Entry Choices

SOURCE: Based on and adapted from Zachary, M.A., P.T. Gianiodis, G. Tyge Payne, and G.D. Markman (2014), "Entry timing: enduring lessons and future directions," *Journal of Management* 41: 1409; and Bryce, D.J., and J.H. Dyer (2007), "Strategies to crack well-guarded markets," *Harvard Business Review*, May: 84–92.



Rather than considering firm entry as a discrete event (i.e., simple yes or no decision), or a discrete event composed of five parts, this model suggests that the entry choices firms make constitute a strategic process unfolding over time.

In particular, to increase the probability of successful entry, strategic leaders need to consider the following five questions:³⁷

1. *Who are the players?* Building on Porter's insight that competition must be viewed in a broader sense beyond direct competitors, the *who are the players* question allows strategic leaders to not only identify direct competitors but also focus on other external and internal stakeholders necessary to successfully compete in an industry, such as customers, employees, regulators, and communities (see discussion of stakeholder strategy in Chapter 2).
2. *When to enter?* This question concerns the *timing of entry*. Given that our perspective is that of a firm considering potential entry into an *existing* industry, any first-mover advantages are bygones. Nonetheless, the potential new entrant needs to consider at which stage of the industry life cycle (introduction, growth, shakeout, maturity, or decline) it should enter. We are taking a deep dive into the industry life cycle and how it unfolds over time in Chapter 7.
3. *How to enter?* One of the challenges that strategic leaders face is that often the most attractive industries in terms of profitability are also the hardest to break into because they are protected by entry barriers. Thus, the *how to enter* question goes to the heart of this problem.
 - One option is to *leverage existing assets*, that is to think about a new combination of resources and capabilities that firms already possess, and if needed to combine them with partner resources through strategic alliances. Although Circuit City went bankrupt as an electronics retailer, losing out to Best Buy and Amazon, a few years earlier it recombined its existing expertise in big-box retailing including optimization of supply and demand in specific geographic areas to create CarMax, now the largest used-car dealer in the United States and a Fortune 500 company.
 - Another option is to *reconfigure value chains*. This approach allowed Skype to enter the market for long-distance calls by combining value chains differently (offering VOIP rather than relying on more expensive fiber-optic cables), and thus compete with incumbents such as AT&T.
 - The third option is to *establish a niche* in an existing industry, and then use this beachhead to grow further. This is the approach the Austrian maker of Red Bull used when entering the U.S. soft drink market, long dominated by Coca-Cola and PepsiCo. Its energy drink was offered in a small 8.3-ounce can, but priced at multiples compared to Coke or Pepsi. This allowed retailers to stock Red Bull cans in small spaces such as near the checkout counter. In addition, Red Bull initially used many nontraditional outlets as points of sale such as nightclubs and gas stations. This approach created a loyal following from which the energy drink maker could expand its entry into the mainstream carbonated beverage drink in the United States and elsewhere. Indeed, energy drinks are now one of the fastest growing segments in this industry.
4. *What type of entry?* The *what* question of entry refers to the type of entry in terms of product market (e.g., smartphones), value chain activity (e.g., R&D for smartphone chips or manufacturing of smartphones), geography (e.g., domestic and/or international), and type of business model (e.g., subsidizing smartphones when providing services). Depending on the market under consideration for entry, firms may face unique competitive and institutional challenges. For example, discount carrier Spirit Airlines' unbundling of its services by charging customers separately for elements such as checked luggage, assigned seating, carry-on items, and other in-flight perks such as

drinks met with considerable backlash in 2007 when introduced. Yet this marked the starting point of Spirit Airlines' strategic positioning as an ultra-low-cost carrier and enabled the company to add many attractive routes, and thus to enter geographic markets it was not able to compete in previously.

5. *Where to enter?* After deciding on the type of entry, the *where* to enter question refers to more fine-tuned aspects of entry such as product positioning (high end versus low end), pricing strategy, potential partners, and so forth.

LO 3-7

Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

INDUSTRY DYNAMICS

Although the five forces plus complements model is useful in understanding an industry's profit potential, it provides only a point-in-time snapshot of a moving target. With this model (as with other static models), one cannot determine the changing speed of an industry or the rate of innovation. This drawback implies that managers must repeat their analysis over time to create a more accurate picture of their industry. It is therefore important that managers consider industry dynamics.

Industry structures are not stable over time. Rather, they are dynamic. Since a consolidated industry tends to be more profitable than a fragmented one (see Exhibit 3.4), firms have a tendency to change the industry structure in their favor, making it more consolidated through horizontal mergers and acquisitions. Having fewer competitors generally equates to higher industry profitability. Industry incumbents, therefore, have an incentive to reduce the number of competitors in the industry. With fewer but larger competitors, incumbent firms can mitigate the threat of strong competitive forces such as supplier or buyer power more effectively.

The U.S. domestic airline industry (featured in Strategy Highlight 3.2) has witnessed several large, horizontal mergers between competitors, including Delta and Northwest, United and Continental, Southwest and AirTran, as well as American and U.S. Airways. These moves allow the remaining carriers to enjoy a more benign industry structure. It also allows them to retire some of the excess capacity in the industry as the merged airlines consolidate their networks of routes. The merger activity in the airline industry provides one example of how firms can proactively reshape industry structure in their favor. A more consolidated airline industry is likely to lead to higher ticket prices and fewer choices for customers, but also more profitable airlines.

In contrast, consolidated industry structures may also break up and become more fragmented. This generally happens when there are external shocks to an industry such as deregulation, new legislation, technological innovation, or globalization. For example, the emergence of the internet moved the stock brokerage business from an oligopoly controlled by full-service firms such as Merrill Lynch and Morgan Stanley to monopolistic competition with many generic online brokers such as Ameritrade, E*Trade, and Scottrade.

Another dynamic to be considered is **industry convergence**, a process whereby formerly unrelated industries begin to satisfy the same customer need. Industry convergence is often brought on by technological advances. For years, many players in the media industries have been converging due to technological progress in IT, telecommunications, and digital media. Media convergence unites computing, communications, and content, thereby causing significant upheaval across previously distinct industries. Content providers in industries such as newspapers, magazines, TV, movies, radio, and music are all scrambling to adapt. Many standalone print newspapers are closing up shop, while others are trying to figure out how to offer online news content for which consumers are willing to pay.³⁸ Internet companies such as Google, Facebook, Instagram (acquired by Facebook), LinkedIn (acquired by Microsoft), Snap, Pinterest, and Twitter are changing the industry structure by constantly morphing their capabilities and forcing old-line media companies

industry convergence

A process whereby formerly unrelated industries begin to satisfy the same customer need.

such as News Corp., Time Warner, and Disney to adapt. A wide variety of mobile devices, including smartphones, tablets, and e-readers, provide a new form of content delivery that has the potential to make print media obsolete.

3.4 Performance Differences within the Same Industry: Strategic Groups

In further analyzing the firm's external environment to explain performance differences, we now move to firms *within the same industry*. As noted earlier in the chapter, a firm occupies a place within a **strategic group**, a set of companies that pursue a similar strategy within a specific industry in their quest for competitive advantage (see Exhibit 3.1).³⁹ Strategic groups differ from one another along important dimensions such as expenditures on research and development, technology, product differentiation, product and service offerings, market segments, distribution channels, and customer service.

To explain differences in firm performance within the same industry, the **strategic group model** clusters different firms into groups based on a few key strategic dimensions.⁴⁰ Even within the same industry, firm performances differ depending on strategic group membership. Some strategic groups tend to be more profitable than others. This difference implies that firm performance is determined not only by the industry to which the firm belongs, but also by its strategic group membership.

The distinct differences across strategic groups reflect the business strategies that firms pursue. Firms in the same strategic group tend to follow a similar strategy. Companies in the same strategic group, therefore, are direct competitors. The rivalry among firms *within* the same strategic group is generally more intense than the rivalry *among* strategic groups: *Intra-group rivalry exceeds inter-group rivalry*. The number of different business strategies pursued within an industry determines the number of strategic groups in that industry. In most industries, strategic groups can be identified along a fairly small number of dimensions. In many instances, two strategic groups are in an industry based on two different business strategies: one that pursues a low-cost strategy and a second that pursues a differentiation strategy (see Exhibit 3.7). We'll discuss each of these generic business strategies in detail in Chapter 6.

LO 3-8

Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

strategic group

The set of companies that pursue a similar strategy within a specific industry.

strategic group model

A framework that explains differences in firm performance within the same industry.

THE STRATEGIC GROUP MODEL

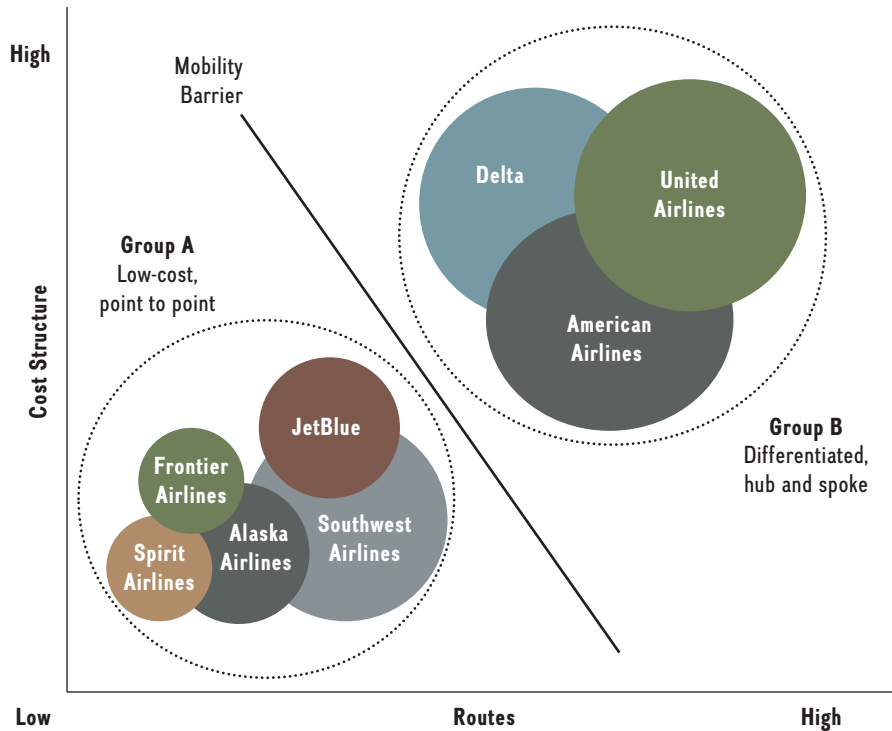
To understand competitive behavior and performance within an industry, we can map the industry competitors into strategic groups. We do this by:

- Identifying the most important strategic dimensions such as expenditures on research and development, technology, product differentiation, product and service offerings, cost structure, market segments, distribution channels, and customer service. These dimensions are strategic commitments based on managerial actions that are costly and difficult to reverse.
- Choosing two key dimensions for the horizontal and vertical axes, which expose important differences among the competitors.
- Graphing the firms in the strategic group, indicating each firm's market share by the size of the bubble with which it is represented.⁴¹

The U.S. domestic airline industry (featured in Strategy Highlight 3.2) provides an illustrative example. Exhibit 3.7 maps companies active in this industry. The two strategic dimensions on the axes are cost structure and routes. As a result of this mapping, two strategic groups become apparent, as indicated by the dashed circles: Group A, low-cost, point-to-point airlines (Alaska Airlines, Frontier Airlines, JetBlue, Southwest Airlines, and Spirit Airlines) and Group B, differentiated airlines using a hub-and-spoke system

EXHIBIT 3.7 /

Strategic Groups and Mobility Barrier in U.S. Domestic Airline Industry



(American, Delta, and United). The low-cost, point-to-point airlines are clustered in the lower-left corner because they tend to have a lower cost structure but generally serve fewer routes due to their point-to-point operating system.

The differentiated airlines in Group B, offering full services using a hub-and-spoke route system, comprise the so-called legacy carriers. They are clustered in the upper-right corner because of their generally higher cost structures. The legacy carriers usually offer many more routes than the point-to-point low-cost carriers, made possible by use of the hub-and-spoke system, and thus offer many different destinations. For example, Delta's main hub is in Atlanta, Georgia.⁴² If you were to fly from Seattle, Washington, to Miami, Florida, you would stop to change planes in Delta's Atlanta hub on your way.

The strategic group mapping in Exhibit 3.7 provides additional insights:

- **Competitive rivalry is strongest between firms that are within the same strategic group.** The closer firms are on the strategic group map, the more directly and intensely they are in competition with one another. After a wave of mergers, the remaining mega-airlines—American, Delta, and United—are competing head-to-head, not only in the U.S. domestic market but also globally. They tend to monitor one another's strategic actions closely. While Delta faces secondary competition from low-cost carriers such as Southwest Airlines (SWA) on some domestic routes, its primary competitive rivals remain the other legacy carriers. This is because they compete more on providing seamless global services within their respective airline alliances (SkyTeam for Delta, Oneworld for American, and Star Alliance for United) than on low-cost fares for particular city pairs in the United States. Nonetheless, when Delta is faced with direct competition from SWA on a particular domestic route (say from Atlanta to Chicago), both tend to offer similar low-cost fares.
- **The external environment affects strategic groups differently.** During times of economic downturn, for example, the low-cost airlines tend to take market share away from the legacy carriers. Moreover, given their generally higher cost structure, the

legacy carriers are often unable to stay profitable during recessions, at least on domestic routes. This implies that external factors such as recessions or high oil prices favor the companies in the low-cost strategic group. On the other hand, given a number of governmental restrictions on international air travel, the few airlines that are able to compete globally usually make a tidy profit in this specific industry segment.

- **The five competitive forces affect strategic groups differently.** *Barriers to entry*, for example, are higher in the hub-and-spoke (differentiated) airline group than in the point-to-point (low-cost) airline group. Following deregulation, many airlines entered the industry, but all of these new players used the point-to-point system. Since hub-and-spoke airlines can offer worldwide service and are protected from foreign competition by regulation to some extent, they often face weaker *buyer power*, especially from business travelers. While the hub-and-spoke airlines compete head-on with the point-to-point airlines when they are flying the same or similar routes, the *threat of substitutes* is stronger for the point-to-point airlines. This is because they tend to be regionally focused and compete with the viable substitutes of car, train, or bus travel. The threat of *supplier power* tends to be stronger for the airlines in the point-to-point, low-cost strategic group because they are much smaller and thus have weaker negotiation power when acquiring new aircraft, for example. To get around this, these airlines frequently purchase used aircraft from legacy carriers. This brief application of the five forces model leads us to conclude that rivalry among existing competitors in the low-cost, point-to-point strategic group is likely to be more intense than within the differentiated, hub-and-spoke strategic group.
- **Some strategic groups are more profitable than others.** Historically, airlines clustered in the lower-left corner tend to be more profitable when considering the U.S. domestic market only. Why? Because they create similar, or even higher, value for their customers in terms of on-time departure and arrival, safety, and fewer bags lost, while keeping their cost structure well below those of the legacy carriers. The point-to-point airlines have generally lower costs than the legacy carriers because they are faster in turning their airplanes around, keep them flying longer, use fewer and older airplane models, focus on high-yield city pairs, and tie pay to company performance, among many other activities that all support their low-cost business model. The point-to-point airlines, therefore, are able to offer their services at a lower cost and a higher perceived value, resulting in more pricing options, and thus creating the basis for a competitive advantage.

MOBILITY BARRIERS

Although some strategic groups tend to be more profitable and therefore more attractive than others, **mobility barriers** restrict movement between groups. These are industry-specific factors that separate one strategic group from another.⁴³ The dimensions to determine a strategic group are mobility barriers, which are strategic commitments. These are actions that are costly and not easily reversed such as the firm's underlying cost structure because it is based on managerial commitments resulting in hard-to-reverse investments.

The two groups identified in Exhibit 3.7 are separated by the fact that offering international routes necessitates the hub-and-spoke model. Frequently, the international routes tend to be the remaining profitable routes left for the legacy carriers; albeit the up-and-coming Persian Gulf region carriers, in particular Emirates, Etihad Airways, and Qatar Airways, are beginning to threaten this profit sanctuary.⁴⁴

This economic reality implies that if carriers in the lower-left cluster, such as SWA or JetBlue, would like to compete globally, they would likely need to change their point-to-point operating model to a hub-and-spoke model. Or they could select a few profitable

mobility barriers
Industry-specific factors
that separate one
strategic group from
another.

international routes and service them with long-range aircrafts such as Boeing 787s or Airbus A-380s. Adding international service to the low-cost model, however, would require managerial commitments resulting in significant capital investments and a likely departure from a well-functioning business model. Additional regulatory hurdles reinforce these mobility barriers, such as the difficulty of securing landing slots at international airports around the world.

Despite using its point-to-point operating system, SWA experienced these and many other challenges when it began offering international flights to selected resort destinations such as Aruba, Cabo San Lucas, Cancun, the Bahamas, and Jamaica: changes to its reservation system, securing passports for crew members, cultural-awareness training, learning instructions in foreign languages, and performing drills in swimming pools on how to evacuate passengers onto life rafts. All of these additional requirements result in a somewhat higher cost for SWA to servicing international routes.⁴⁵

3.5 Implications for Strategic Leaders

At the start of the strategic management process, it is critical for managers to conduct a thorough analysis of the firm's external environment to identify threats and opportunities. The initial step is to apply a PESTEL analysis to scan, monitor, and evaluate changes and trends in the firm's macroenvironment. This versatile framework allows managers to track important trends and developments based on the *source* of the external factors: political, economic, sociocultural, technological, ecological, and legal. When applying a PESTEL analysis, the guiding consideration for strategic leaders should be the question of how the external factors identified affect the firm's industry environment.

Exhibit 3.1 delineates external factors based on the *proximity* of these external factors by gradually moving from the general to the task environment. The next layer for managers to understand is the industry. Applying Porter's five forces model allows strategic leaders to understand the profit potential of an industry and to obtain clues on how to carve out a strategic position that makes gaining and sustaining a competitive advantage more likely. Follow these steps to apply the five forces model:⁴⁶

1. **Define the relevant industry.** In the five forces model, industry boundaries are drawn by identifying a group of incumbent companies that face more or less the same suppliers and buyers. This group of competitors is likely to be an industry if it also has the same entry barriers and a similar threat from substitutes. In this model, therefore, an industry is defined by commonality and overlap in the five competitive forces that shape competition.
2. **Identify the key players in each of the five forces and attempt to group them into different categories.** This step aids in assessing the relative strength of each force. For example, while makers of jet engines (GE, Rolls-Royce, Pratt & Whitney) and local catering services are all suppliers to airlines, their strengths vary widely. Segmenting different players within each force allows you to assess each force at a fine-grained level.
3. **Determine the underlying drivers of each force.** Which forces are strong, and which are weak? And why? Keeping with the airline example, why is the supplier power of jet engine manufacturers strong? Because they are supplying a mission-critical, highly differentiated product for airlines. Moreover, there are only a few suppliers of jet engines worldwide and no viable substitutes.
4. **Assess the overall industry structure.** What is the industry's profit potential? Here you need to identify forces that directly influence industry profit potential, because not all forces are likely to have an equal effect. Focus on the most important forces that drive industry profitability.

The final step in industry analysis is to draw a strategic group map. This exercise allows you to unearth and explain *performance differences within the same industry*. When analyzing a firm's external environment, it is critical to apply the three frameworks introduced in this chapter (PESTEL, Porter's five forces, and strategic group mapping). Taken together, the external environment can determine up to roughly one-half of the performance differences across firms (see Exhibit 1.1).

Although the different models discussed in this chapter are an important step in the strategic management process, they are not without shortcomings. First, all of the models presented are *static*. They provide a snapshot of what is actually a moving target and do not allow for consideration of industry dynamics. However, changes in the external environment can appear suddenly, for example, through black swan events. Industries can be revolutionized by innovation. Strategic groups can be made obsolete through deregulation or technological progress. To overcome this important shortcoming, strategic leaders must conduct external analyses at different points in time to gain a sense of the underlying *dynamics*. The frequency with which these tools need to be applied is a function of the rate of change in the industry. The mobile app industry is changing extremely fast, while the railroad industry experiences a less volatile environment.

Second, the models presented in this chapter do not allow strategic leaders to fully understand *why* there are performance differences among firms in the *same* industry or strategic group. To better understand differences in firm performance, we must look *inside the firm* to study its resources, capabilities, and core competencies. We do this in the next chapter by moving from external to internal analysis.

CHAPTERCASE 3 / Consider This . . .

Even though Airbnb is at \$31 billion one of the most valuable private startups in the world and offers more accommodations than the three largest hotel chains (Marriott, Hilton, and Intercontinental) combined, not all is smooth sailing. In particular, PESTEL factors discussed in this chapter are creating major headwinds for Airbnb. Take regulation, for example. In late 2016, New York state strengthened legislation first passed in 2010. In particular, it is illegal in New York to rent out entire apartments in residential blocks for less than 30 days. (It still remains legal if the renter is living in the apartment at the same time, so "true space sharing" is still possible.) Fines increased to \$1,000 for the first offense, rising to \$7,500 for repeat offenders. This creates major problems for Airbnb because New York City is by far the largest market for the internet venture, with some 35,000 accommodations available for rent.

The issue for Airbnb is that about one-third of those listings are from hosts with multiple offerings in the same city. In particular, commercial landlords found out that it is more profitable to convert some apartments into short-term rentals

and to offer them via Airbnb than to sign long-term rentals with just one tenant, which often fall under some sort of rent control in New York City. Although this tactic increases the landlord's return on investment and profits, it creates all kinds of negative externalities. Neighbors complain about noisy tourists partying all night. Some apartments get ransacked or are used for illegal activities such as drug deals and prostitution. New Yorkers expressed their frustration by scrawling on Airbnb posters: "The dumbest person in your building is passing out keys to your front door!" On a more macro level, some argue that Airbnb drives out affordable rental space in many metropolitan cities where apartments are already scarce. Other cities such as Paris, Berlin, and Barcelona face similar problems and passed laws with stiff penalties, fining offenders over \$100,000!

Questions

1. Have you ever used Airbnb, either as a renter or a host? What were some of the positives and some of the negatives of your experience? Explain.

2. How was an internet startup able to disrupt the hotel industry, long dominated by giants such as Marriott and Hilton, which took decades to become successful world-wide hospitality chains? Explain.
3. Why is it that PESTEL factors can have such a strong impact on the future of a business? Do you support legislation such as that passed in New York (and elsewhere), or do you think it has more to do with protecting vested interests such as the hotel industry?
4. Citing the Digital Millennium Copyright Act (DMCA), Airbnb is challenging the New York law and others in the United States, arguing that it merely operates a digital marketplace, and thus is not responsible for the content that users place on its site. Do you think Airbnb has a strong argument? Why or why not?
5. Are you concerned that the concept of the sharing economy could be abused by unscrupulous “entrepreneurs” and thus give the entire novel concept a bad reputation? Why or why not? Explain.

TAKE-AWAY CONCEPTS

This chapter demonstrated various approaches to analyzing the firm's *external environment*, as summarized by the following learning objectives and related take-away concepts.

LO 3-1 / Generate a PESTEL analysis to evaluate the impact of external factors on the firm.

- A firm's macroenvironment consists of a wide range of political, economic, sociocultural, technological, ecological, and legal (PESTEL) factors that can affect industry and firm performance. These external factors have both domestic and global aspects.
- Political factors describe the influence governmental bodies can have on firms.
- Economic factors to be considered are growth rates, interest rates, levels of employment, price stability (inflation and deflation), and currency exchange rates.
- Sociocultural factors capture a society's cultures, norms, and values.
- Technological factors capture the application of knowledge to create new processes and products.
- Ecological factors concern a firm's regard for environmental issues such as the natural environment, global warming, and sustainable economic growth.

- Legal factors capture the official outcomes of the political processes that manifest themselves in laws, mandates, regulations, and court decisions.

LO 3-2 / Differentiate the roles of firm effects and industry effects in determining firm performance.

- A firm's performance is more closely related to its managers' actions (firm effects) than to the external circumstances surrounding it (industry effects).
- Firm and industry effects, however, are interdependent. Both are relevant in determining firm performance.

LO 3-3 / Apply Porter's five competitive forces to explain the profit potential of different industries.

- The profit potential of an industry is a function of the five forces that shape competition: (1) threat of entry, (2) power of suppliers, (3) power of buyers, (4) threat of substitutes, and (5) rivalry among existing competitors.
- The stronger a competitive force, the greater the threat it represents. The weaker the competitive force, the greater the opportunity it presents.
- A firm can shape an industry's structure in its favor through its strategy.

LO 3-4 / Examine how competitive industry structure shapes rivalry among competitors.

- The competitive structure of an industry is largely captured by the number and size of competitors in an industry, whether the firms possess some degree of pricing power, the type of product or service the industry offers (commodity or differentiated product), and the height of entry barriers.
- A perfectly competitive industry is characterized by many small firms, a commodity product, low entry barriers, and no pricing power for individual firms.
- A monopolistic industry is characterized by many firms, a differentiated product, medium entry barriers, and some pricing power.
- An oligopolistic industry is characterized by few (large) firms, a differentiated product, high entry barriers, and some degree of pricing power.
- A monopoly exists when there is only one (large) firm supplying the market. In such instances, the firm may offer a unique product, the barriers to entry may be high, and the monopolist usually has considerable pricing power.

LO 3-5 / Describe the strategic role of complements in creating positive-sum co-opetition.

- Co-opetition (cooperation among competitors) can create a positive-sum game, resulting in a larger pie for everyone involved.
- Complements increase demand for the primary product, enhancing the profit potential for the industry and the firm.
- Attractive industries for co-opetition are characterized by high entry barriers, low exit barriers, low buyer and supplier power, a low threat of substitutes, and the availability of complements.

LO 3-6 / Explain the five choices required for market entry.

- The more profitable an industry, the more attractive it becomes to competitors, who must consider the *who*, *when*, *how*, *what*, and *where* of entry.
- The five choices constitute more than parts of a single decision point; their consideration forms a

strategic process unfolding over time. Each choice involves multiple decisions including many dimensions.

- *Who* includes questions about the full range of stakeholders, and not just competitors; *when*, questions about the industry life cycle; *how*, about overcoming barriers to entry; *what*, about options among product market, value chain, geography, and business model; and *where*, about product positioning, pricing strategy, and potential partners.

LO 3-7 / Appraise the role of industry dynamics and industry convergence in shaping the firm's external environment.

- Industries are dynamic—they change over time.
- Different conditions prevail in different industries, directly affecting the firms competing in these industries and their profitability.
- In industry convergence, formerly unrelated industries begin to satisfy the same customer need. Such convergence is often brought on by technological advances.

LO 3-8 / Generate a strategic group model to reveal performance differences between clusters of firms in the same industry.

- A strategic group is a set of firms within a specific industry that pursue a similar strategy in their quest for competitive advantage.
- Generally, there are two strategic groups in an industry based on two different business strategies: one that pursues a low-cost strategy and a second that pursues a differentiation strategy.
- Rivalry among firms of the same strategic group is more intense than the rivalry between strategic groups: intra-group rivalry exceeds inter-group rivalry.
- Strategic groups are affected differently by the external environment and the five competitive forces.
- Some strategic groups are more profitable than others.
- Movement between strategic groups is restricted by mobility barriers—industry-specific factors that separate one strategic group from another.

KEY TERMS

Competitive industry structure (p. 83)	Firm effects (p. 73)	Network effects (p. 77)
Complement (p. 88)	Five forces model (p. 74)	PESTEL model (p. 67)
Complementor (p. 88)	Industry (p. 73)	Strategic commitments (p. 87)
Co-opetition (p. 88)	Industry analysis (p. 73)	Strategic group (p. 93)
Entry barriers (p. 76)	Industry convergence (p. 92)	Strategic group model (p. 93)
Exit barriers (p. 87)	Industry effects (p. 73)	Strategic position (p. 73)
	Mobility barriers (p. 95)	Threat of entry (p. 76)

DISCUSSION QUESTIONS

1. Why is it important for any organization (firms, nonprofits, etc.) to study and understand its external environment?
2. How do the five competitive forces in Porter's model affect the average profitability of the industry? For example, in what way might weak forces increase industry profits, and in what way do strong forces reduce industry profits? Identify an industry in which many of the competitors seem to be having financial performance problems. Which of the five forces seems to be strongest?
3. This chapter covers the choices firms make in entering new markets (LO 3-6). Reflect on ChapterCase 3 and discuss how Airbnb might have answered these questions in Exhibit 3.6.
4. How do mobility barriers affect the structure of an industry? How do they help us explain firm differences in performance?

ETHICAL/SOCIAL ISSUES

1. One of the world's largest car manufacturers, Volkswagen (VW), admitted to criminal wrongdoing in 2017. The firm confirmed that it systematically cheated on emissions tests related to its two-liter diesel engines. These engines were designed in 2005 to meet more rigorous U.S. emission standards taking effect in 2007. Apparently the new engines did not perform as planned and the company then designed a software feature to artificially pass the emissions testing process. Road testing in 2014 uncovered a large difference between EPA-measured emissions and the actual output of the vehicles. This was then further investigated by several legal entities. In September 2015 the CEO of VW lost his job over the scandal. The financial cost to the firm is currently more than \$20 billion and could go above \$25 billion in fines and consumer compensation for nearly 11 million vehicles with this "defeat device" software.⁴⁷
 - a. The external environment of the global automobile industry is quite complex. Regulations vary from country to country and in the United States even from one state to another in some cases. Firms must be prepared to anticipate and respond to these external forces. It appears VW's response to the design issue, in this case, was neither ethical nor legal. Why do you think VW made the decisions it did regarding this emissions problem in the late 2000s? What could VW have done differently?
 - b. In January 2017, a U.S. grand jury indicted six current and former VW executives for their alleged role in the emissions scandal and its subsequent cover-up. The U.S. Justice

Department decided to bring charges against these executives after a 16-month criminal investigation by the FBI. In the past, it has been rare for executives to be personally indicted for company misconduct. Do you agree with the decision to go after individual managers in this case? Why or why not?

- c. What are the competitive implications of the actions of VW? Does this situation impact the industry rivalry that is discussed in the five forces model, for instance?
2. The chapter notes that national governments provide incentives for industry growth. One such example is for the purchase of electric vehicles (EVs). Norway, for example, has provided tax discounts for electric vehicles since the 1990s. Norway waives a substantial automobile import

tax on EVs sold inside the country. Largely as a result of these policies, 22 percent of the automobiles owned in Norway were electric powered in 2015. This compares with 0.5 percent in the United States, 0.8 percent in China, and 1.1 percent in the United Kingdom in 2015.⁴⁸

- a. What is the appropriate role for governments to encourage or discourage certain purchasing behaviors? You may note many national governments have for decades collected additional taxes on tobacco and alcohol products as a measure to try to moderate consumption of these items.
- b. As a strategist in a major firm, how would you seek to position your company in light of such current and potential future governmental policies?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Your group is a team of KraftHeinz Co. (www.kraftheinzcompany.com) marketing interns. The company has asked you to propose new guidelines for helping it promote food to children in a socially responsible way. As the fifth-largest consumer packaged food and beverage company globally, KraftHeinz's 2016 sales exceeded \$26 billion. The company projects steady growth, but would like your help in boosting growth. One of Kraft's largest brands is Oscar Mayer Lunchables, described as making lunch fun and targeted to busy parents who want a quick lunch to send with their children to school or keep on hand as an after-school snack. One of the options is Lunchables with Juice, Nachos Cheese Dip, and Salsa. However, controversy is growing about the social responsibility of directly marketing to children when the food is unhealthy—high in fat, sugar, and salt, but low in nutrition. There is a societal concern with the growing rate of obesity in children and the increased incidence of diabetes that results from childhood obesity.

Kraft would like to have a reputation as a socially responsible company. Accordingly, Kraft would like to create internal guidelines that will help it market Lunchables (as well as other packaged food items) responsibly and gain the approval of medical professionals, parents, and watchdog groups.⁴⁹

1. Visit the Kraft food website (www.lunchables.com) and review the Lunchables products, as well as other packaged food products that Kraft offers. Discuss among your group members the extent to which the product options are healthy choices.
2. Identify other actions that Kraft might take to demonstrate that it is a food company that genuinely cares about children's health and a company that would like to help reverse the trend of increasing childhood obesity.
3. If your group believes that the company is not responsible for personal choices that consumers make to eat unhealthy food, then describe how the company should respond to activist groups and public health officials that are urging companies to stop producing and marketing unhealthy foods.

//// Small Group Exercise 2

One industry with an impact on both undergraduate and MBA students is textbook publishing. Traditional printed textbooks are being challenged on one hand by self-publishing firms offering very low prices for specific instructor materials, and on the other hand by a need to offer digital resources that substitute for printed materials. Large textbook publishers are increasingly

investing in adaptive learning systems such as Wiley-PLUS, Cengage MindTap, and McGraw-Hill Connect. Complicating factors for the publishers is the changing business model of renting textbooks (printed and electronic). U.S. university book rental was about 25 percent of student purchasing volume in 2015.⁵⁰

Use the five forces model (with complements) to think through the various impacts such technology

shifts may have on the textbook industry. Include in your response answers to the following questions.

1. How should managers of a textbook publishing company respond to such changes?
2. Will the shifts in technology and business models be likely to raise or lower the textbook industry profits? Explain.

mySTRATEGY

Is My Job the Next One Being Outsourced?

The outsourcing of IT programming jobs to India is now commonly understood after years of this trend. However, more recently some accounting functions have also begun to flow into India's large technically trained and English-speaking work force. For example, the number of U.S. tax returns completed in India rose dramatically from 2003 to 2011 (25,000 in 2003 to 1.6 million in 2011). Some estimate that over 20 million U.S. tax returns will be prepared in India within the next few years. Outsourcing accounting functions may affect the job and career prospects for accounting-oriented business school graduates. Tax accountants in Bangalore, India, are much cheaper than those in Boston or Baltimore. Moreover, tax accountants in India often work longer hours and can therefore process many more tax returns than U.S.-based CPAs and tax accountants during the crunch period of the U.S. tax filing system.⁵¹ Other services once thought to be immune to offshoring are also experiencing vulnerability. One example is the rise in medical tourism for major medical treatments to handle

everything from joint replacements, weight loss, dental problems, and infertility. It is estimated that over 14 million patients traveled from one country to another seeking medical treatment in 2016 alone.⁵²

1. Which aspects of accounting do you think are more likely to resist the outsourcing trends just discussed? Think about what aspects of accounting are the high-value activities versus the routine standardized ones. (If it's been a while since you took your accounting courses, reach out for information to someone in your strategy class who is an accounting major.)
2. What industries do you think may offer the best U.S. (or domestic) job opportunities in the future? Which industries do you think may offer the greatest job opportunities in the global market in the future? Use the PESTEL framework and the five forces model to think through a logical set of reasons that some fields will have higher job growth trends than others.
3. Do these types of macroenvironmental and industry trends affect your thinking about selecting a career field after college? Why or why not? Explain.

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CHAPTER

4

Internal Analysis: Resources, Capabilities, and Core Competencies

Chapter Outline

- 4.1** Core Competencies
- 4.2** The Resource-Based View
 - Two Critical Assumptions*
 - The VRIO Framework*
 - Isolating Mechanisms: How to Sustain a Competitive Advantage*
- 4.3** The Dynamic Capabilities Perspective
- 4.4** The Value Chain and Strategic Activity Systems
 - The Value Chain*
 - Strategic Activity Systems*
- 4.5** Implications for Strategic Leaders
 - Using SWOT Analysis to Generate Insights from External and Internal Analysis*

Learning Objectives

- LO 4-1** Differentiate among a firm's core competencies, resources, capabilities, and activities.
- LO 4-2** Compare and contrast tangible and intangible resources.
- LO 4-3** Evaluate the two critical assumptions behind the resource-based view.
- LO 4-4** Apply the VRIO framework to assess the competitive implications of a firm's resources.
- LO 4-5** Evaluate different conditions that allow a firm to sustain a competitive advantage.
- LO 4-6** Outline how dynamic capabilities can enable a firm to sustain a competitive advantage.
- LO 4-7** Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into outputs generate differentiation and which drive costs.
- LO 4-8** Identify competitive advantage as residing in a network of distinct activities.
- LO 4-9** Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

Dr. Dre's Core Competency: Coolness Factor

IN 2014, DR. DRE—whose real name is Andre Young—was celebrated as the first hip-hop billionaire after Apple acquired Beats Electronics for \$3 billion. Dr. Dre has a long track record as a successful music producer, rapper, and entrepreneur. Known for his strong work ethic, he expects nothing less than perfection from the people he works with—similar to some of the personality attributes ascribed to the late Steve Jobs, co-founder and longtime CEO of Apple.

Although Dr. Dre created and subsequently sold several successful music record labels, as an entrepreneur he is best known as co-founder of Beats Electronics with Jimmy Iovine, also an entrepreneur and record and film producer. Both are considered to be some of the best-connected businesspeople in the music industry, with personal networks spanning hundreds of both famous and up-and-coming artists. Founded in 2008, Beats Electronics is known globally for its premium consumer headphones, Beats by Dr. Dre, which he claims allows the listeners to “hear all the music.” Since early 2014, the company also offers the streaming music subscription service Beats Music. Beats’ vision is to “bring the energy, emotion, and excitement of playback in the recording studio to the listening experience and introduce an entirely new generation to the possibilities of premium sound entertainment.”¹ Many acoustics experts maintain, however, that playback of digitally compressed MP3 audio files is inferior in comparison to high fidelity. Moreover, the sound quality of Beats headphones is considered poor in comparison to other premium-brand headphones such as those by Bose, JBL, Sennheiser, and others.

Why then would Apple pay \$3 billion to acquire Beats Electronics? This was by far the largest acquisition in Apple’s history. Two main reasons: First, Apple is hoping that some of Beats’ coolness will spill over to its brand, which has become somewhat stale. Apple’s iPhones, for example, have become a somewhat standardized commodity given the successful imitation by Samsung and others, although Apple has high expectations for its 10th anniversary iPhone, released in the

fall of 2017. Second, although Apple is the world’s largest music vendor with 800 million accounts on iTunes Store, the industry is being disrupted. Content delivery, especially in music but also video (think Netflix), is moving rapidly from ownership via downloads to streaming on demand. As a consequence, music downloads have been declining in the past few years.



Dr. Dre, left, and Jimmy Iovine are co-founders of Beats. Following Apple’s acquisition of Beats, Dre and Iovine continue to work together to keep Beats relevant and tied to current artists.

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BEATS’ COOLNESS FACTOR

Beats by Dr. Dre achieved an unprecedented coolness factor with celebrity endorsements not only from music icons but also athletes, actors, and other stars. Before Beats, no musician endorsed audio headphones in the same way as a basketball player such as Michael Jordan endorsed his line of Nike shoes, Air Jordan. Dr. Dre was the first legendary music producer to endorse premium headphones. In addition, he created custom Beats for stars such as Justin Bieber, Lady Gaga, and Nicki Minaj. Other music celebrities including Skrillex, Lil Wayne, and will.i.am endorsed Beats by wearing them in their music videos and at live events and mentioning them on social media. But Beats did not stop at musicians. Famous athletes—basketball superstars LeBron James and Kobe Bryant, tennis player Serena Williams, and soccer stars Cristiano Ronaldo and Neymar Jr.—wear Beats by Dr. Dre in public and endorse the brand in advertisements.

DISRUPTION IN CONTENT DELIVERY

Content delivery is rapidly moving from ownership through downloads to renting via online streaming. This disruption in the business model is most visible in movies, as the success of Netflix demonstrates, but is also gaining steam in music. Apple is a laggard in music streaming when compared to leaders such as Pandora with 250 million users and Spotify with 100 million users (of whom 50 million are paying customers). Apple's initial attempt at online music streaming service, iTunes Radio created in 2013, has been falling flat. After disrupting the music download space with iTunes in 2003, Apple is now being disrupted by others that lead in music streaming. Apple is hoping that by acquiring Beats

Music it can become a leader in the music streaming space. Renamed Apple Music, the service now has 20 million paid subscribers. Yet it faces competition in the “coolness space” with the music streaming service Tidal, founded by rap mogul Jay Z. Tidal has exclusive release contracts with superstar artists such as Kanye West, Rihanna, and Beyoncé (who is married to Jay Z). Tidal, however, only has some 2 million paid subscribers. The network provider Sprint, nonetheless, acquired one-third of Tidal in 2017.²

You will learn more about Beats Electronics by reading this chapter; related questions appear in “ChapterCase 4 / Consider This. . . .”

 **ONE OF THE KEY** messages of this chapter is that a firm's ability to gain and sustain competitive advantage is partly driven by *core competencies*—unique strengths that are embedded deep within a firm. Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at lower cost. So what are core competencies of Beats by Dr. Dre? Beats succeeds not because it provides the best possible acoustic experience, but because it functions as a fashion statement that communicates coolness.³ The iconic headphones are worn by celebrities from music, movies, and sports. Even fashion designer Marc Jacobs had models wear Beats headphones during runway shows. The extent to which Beats succeeds at product placements with celebrities across the world is unprecedented. The genius behind Beats is creating a perception that if you want to be as cool as one of your heroes, you need to shell out hundreds of dollars to wear plastic headphones in public.

Beats' unique strengths in establishing a brand that communicates coolness is built upon Dr. Dre's intuition and feel for music and cultural trends; Dr. Dre is one of music's savviest marketing minds. Although the sound quality of Beats headphones is good enough, they mainly sell as a fashion accessory for their coolness factor and brand image. Dr. Dre relies on gut instinct in making decisions, while shunning market research. This approach is quite similar to Apple's late co-founder Steve Jobs who made no secret of his disdain for market research because he believed that consumers don't really know what they want until someone else shows it to them.

Beats' core competency in marketing allows the company to differentiate its products from rival offerings because it is able to create higher perceived value for its customers. In turn, Beats' core competency affords the firm a competitive advantage. It is hugely successful: Beats holds some 65 percent market share in the premium headphone market, priced at \$100 and up. Beats' competitive advantage was rewarded with a \$3 billion acquisition by Apple.

In this chapter, we study analytical tools to explain why differences in firm performance exist even within the *same* industry. For example, why does Beats Electronics outperform Audio-Technica, Bose, JBL, Skullcandy, Sennheiser, and Sony in the high-end, premium headphone market? Since these companies compete in the same industry and face similar external opportunities and threats, the source for some of the observable performance difference must be found *inside the firm*. When discussing industry, firm, and other effects in

explaining superior performance, we noted that up to 55 percent of the overall performance differences is explained by firm-specific effects (see Exhibit 3.2). Looking inside the firm to analyze its resources, capabilities, and core competencies allows us to understand the firm's strengths and weaknesses. Linking these insights from a firm's internal analysis to the ones derived in Chapter 3 on external analysis allows managers to determine their strategic options. Ideally, firms want to leverage their internal strengths to exploit external opportunities, and to mitigate internal weaknesses and external threats.

Exhibit 4.1 depicts how and why we move from the firm's external environment to its internal environment. To formulate and implement a strategy that enhances the firm's chances of gaining and sustaining competitive advantage, the firm must have certain types of resources and capabilities that combine to form core competencies. The best firms conscientiously identify their core competencies, resources, and capabilities to survive and succeed. Firms then determine how to manage and develop internal strengths to respond to the challenges and opportunities in their external environment. In particular, firms conduct the evaluation and development of internal strengths in the context of external PESTEL forces and competition within its industry and strategic group.

The firm's response is dynamic. Rather than creating a onetime and thus a static fit, the firm's internal strengths need to change with its external environment in a *dynamic* fashion. At each point the goal should be to develop resources, capabilities, and competencies that create a *strategic fit* with the firm's environment. The forward motion of those environmental forces must also be considered. The chapter will provide a deeper understanding of the *sources* of competitive advantage that reside within a firm.

To gain a better understanding of why and how firm differences explain competitive advantage, we begin this chapter by taking a closer look at *core competencies*. Next, we introduce the *resource-based view* of the firm to provide an analytical model that allows us to assess resources, capabilities, and competencies and their potential for creating a sustainable competitive advantage. We discuss the *dynamic capabilities perspective*, a model that emphasizes a firm's ability to modify and leverage its resource base to gain

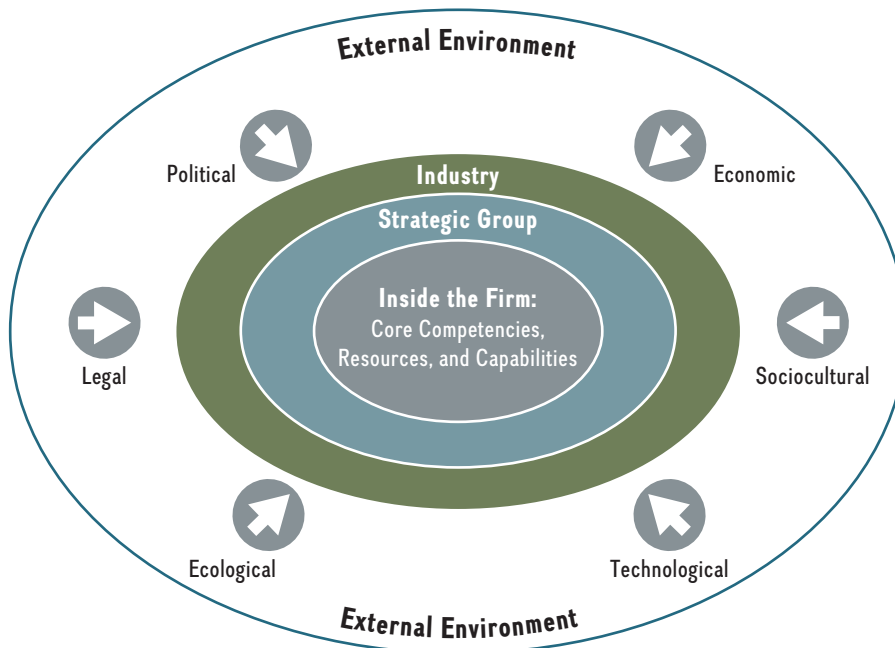


EXHIBIT 4.1 /
Inside the Firm:
Competitive
Advantage based on
Core Competencies,
Resources, and
Capabilities

and sustain a competitive advantage in a constantly changing environment. We then turn our attention to the *value chain analysis* to gain a deeper understanding of the internal activities a firm engages in when transforming inputs into outputs. Next, we take a closer look at *strategic activity systems*. Here, a firm's competitive advantages resides in a network of interconnected and reinforcing activities. We conclude with *Implications for Strategic Leaders*, with a particular focus on how to use the *SWOT analysis* to obtain strategic insights from combining external with internal analysis.

LO 4-1

Differentiate among a firm's core competencies, resources, capabilities, and activities.

4.1 Core Competencies

Let's begin by taking a closer look at **core competencies**. These are unique strengths, embedded deep within a firm. Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at lower cost. The important point here is that competitive advantage can be driven by core competencies.⁴

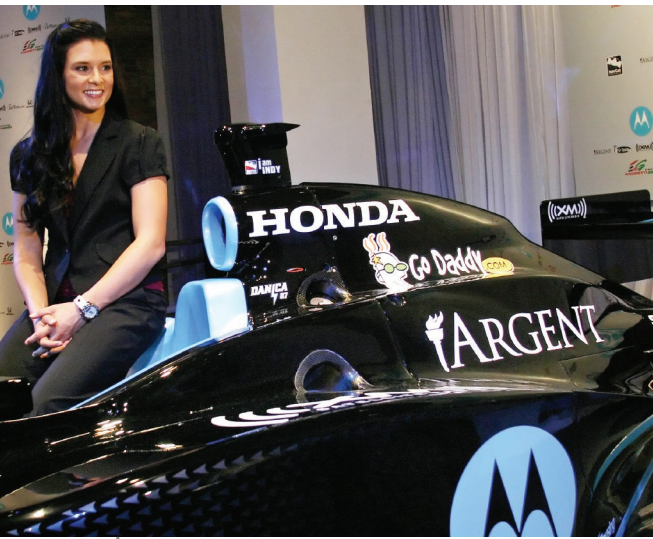
Take Honda as an example of a company with a clearly defined core competency. Its life began with a small two-cycle motorbike engine. Through continuous learning over several decades, and often from lessons learned from failure, Honda built the core competency to design and manufacture small but powerful and highly reliable engines for which it now is famous. This core competency results from superior engineering know-how and

skills carefully nurtured and honed over several decades. Honda's business model is to find a place to put its engines. Today, Honda engines can be found everywhere: in cars, SUVs, vans, trucks, motorcycles, ATVs, boats, generators, snowblowers, lawn mowers and other yard equipment, and even small airplanes. Due to their superior performance, Honda engines have been the most popular in the Indy Racing League (IRL) since 2006. Not coincidentally, this was also the first year in its long history that the Indy 500 was run without a single engine problem.

One way to look at Honda is to view it as a company with a distinct competency in engines and a business model of finding places to put its engines. That is, underneath the products and services that make up the *visible* side of competition lies a diverse set of *invisible* competencies that make this happen. These invisible core competencies reside deep within the firm. Companies, therefore, compete as much in the product and service markets as they do in developing and leveraging core competencies. Although invisible by themselves,

core competencies find their expression in superior products and services. Exhibit 4.2 identifies the core competencies of a number of companies, with application examples.

Since core competencies are critical to gaining and sustaining competitive advantage, it is important to understand how they are created. Companies develop core competencies through the interplay of resources and capabilities. Exhibit 4.3 shows this relationship. **Resources** are any assets such as cash, buildings, machinery, or intellectual property that a firm can draw on when crafting and executing a strategy. Resources can be either tangible or intangible. **Capabilities** are the organizational and managerial skills necessary to



Honda promotes its expertise with engines by sponsoring race car driver Danica Patrick.

©AP Images/Julio Cortez

core competencies Unique strengths, embedded deep within a firm, that are critical to gaining and sustaining competitive advantage.

resources Any assets that a firm can draw on when formulating and implementing a strategy.

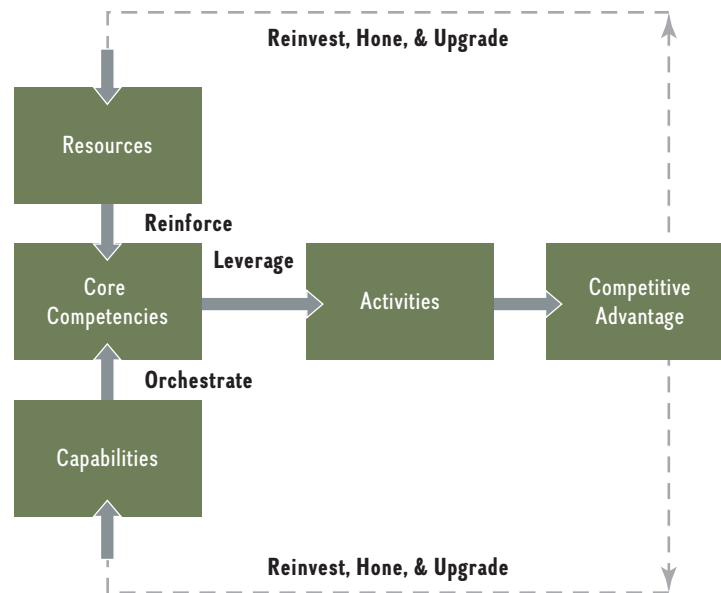
capabilities Organizational and managerial skills necessary to orchestrate a diverse set of resources and deploy them strategically.

EXHIBIT 4.2 / Company Examples of Core Competencies and Applications

Company	Core Competencies	Application Examples
Amazon.com	• Superior IT capabilities. • Superior customer service.	• Online retailing: Largest selection of items online. • Cloud computing: Largest provider through Amazon Web Services (AWS).
Apple	• Superior industrial design in integration of hardware and software. • Superior marketing and retailing experience. • Establishing an ecosystem of products and services that reinforce one another in a virtuous fashion.	• Creation of innovative and category-defining mobile devices and software services that take the user's experience to a new level (e.g., iMac, iPod, iTunes, iPhone, iPad, Apple Pay, and Apple Watch).
Beats Electronics	• Superior marketing: creating a perception of coolness. • Establishing an ecosystem, combining hardware (headphones) with software (streaming service).	• Beats by Dr. Dre and Beats Music.
Coca-Cola	• Superior marketing and distribution.	• Leveraging one of the world's most recognized brands (based on its original "secret formula") into a diverse lineup of soft drinks. • Global availability of products.
ExxonMobil	• Superior at discovering and exploring fossil-fuel-based energy sources globally.	• Focus on oil and gas (fossil fuels only, not renewables).
Facebook	• Superior IT capabilities to provide reliable social network services globally on a large scale. • Superior algorithms to offer targeted online ads.	• Connecting 2 billion social media users worldwide. • News feed, timeline, graph search, and stories.
General Electric	• Superior expertise in industrial engineering, designing and implementing efficient management processes, and developing and training leaders.	• Providing products and services to solve tough engineering problems in energy, health care, and aerospace, among other sectors.
Google (a subsidiary of Alphabet)	• Superior in creating proprietary algorithms based on large amounts of data collected online.	• Software products and services for the internet and mobile computing, including some mobile devices (Pixel phone, Chromebook). • Online search, Android mobile operating system, Chrome OS, Chrome web browser, Google Play, AdWords, AdSense, Google docs, Gmail, etc.
Honda	• Superior engineering of small but powerful and highly reliable internal combustion engines.	• Motorcycles, cars, ATVs, sporting boats, snowmobiles, lawn mowers, small aircraft, etc.
IKEA	• Superior in designing modern functional home furnishings at low cost. • Superior retail experience.	• Fully furnished room setups, practical tools for all rooms, do-it-yourself.
McKinsey	• Superior in developing practice-relevant knowledge, insights, and frameworks in strategy.	• Management consulting; in particular, strategy consulting provided to company and government leaders.
Netflix	• Superior in creating proprietary algorithms-based individual customer preferences.	• DVD-by-mail rentals, streaming media (including proprietary) content, connection to game consoles.
Tesla	• Superior engineering expertise in designing high-performance battery-powered motors and power trains. • Superior expertise in decentralized power storage and management based on renewable (solar) energy.	• Model S, Model X, and Model 3. • Powerwall, solar roof tiles, and complete rooftop solar systems.
Uber	• Superior mobile-app-based transportation and logistics expertise focused on cities, but on global scale.	• Uber, UberX, UberBlack, UberLUX, UberSUV, etc.

EXHIBIT 4.3 /

Linking Core Competencies, Resources, Capabilities, and Activities to Competitive Advantage



orchestrate a diverse set of resources and to deploy them strategically. Capabilities are by nature intangible. They find their expression in a company's structure, routines, and culture.

As shown in Exhibit 4.3, such competencies are demonstrated in the company's activities, which can lead to competitive advantage, resulting in superior firm performance. **Activities** are distinct and fine-grained business processes such as order taking, the physical delivery of products, or invoicing customers. Each distinct activity enables firms to add incremental value by transforming inputs into goods and services. In the interplay of resources and capabilities, resources reinforce core competencies, while capabilities allow managers to orchestrate their core competencies. Strategic choices find their expression in a set of specific firm activities, which leverage core competencies for competitive advantage. The arrows leading back from competitive advantage to resources and capabilities indicate that superior performance in the marketplace generates profits that can be reinvested into the firm (retained earnings) to further hone and upgrade a firm's resources and capabilities in its pursuit of achieving and maintaining a strategic fit within a dynamic environment.

We should make two more observations about Exhibit 4.3 before moving on. First, core competencies that are not continuously nourished will eventually lose their ability to yield a competitive advantage. And second, in analyzing a company's success in the market, it can be too easy to focus on the more *visible* elements or facets of core competencies such as superior products or services. While these are the outward manifestation of core competencies, what is even more important is to understand the *invisible* part of core competencies. As to the first point, let's consider the consumer electronics industry. For some years, Best Buy outperformed Circuit City based on its strengths in customer-centricity (segmenting customers based on demographic, attitudinal, and value tiers, and configuring stores to serve the needs of the customer segments in that region), employee development, and exclusive branding. Although Best Buy outperformed Circuit City (which filed for bankruptcy in 2009), more recently Best Buy did not hone and upgrade its core competencies sufficiently to compete effectively against Amazon.com, the world's largest online retailer. Amazon does not have the overhead expenses associated with maintaining buildings or human sales forces; therefore, it has a lower cost structure and thus can undercut in-store retailers on price. When a firm does not invest in continual upgrading or improving

activities Distinct and fine-grained business processes that enable firms to add incremental value by transforming inputs into goods and services.

core competencies, its competitors are more likely to develop equivalent or superior skills, as did Amazon. This insight will allow us to explain differences between firms in the same industry, as well as competitive dynamics, over time. It also will help us identify the strategy with which firms gain and sustain a competitive advantage and weather an adverse external environment.

As to the second point, we will soon introduce tools to help bring more opaque aspects of a firm's core competencies into the daylight to be seen with clarity. We start by looking at both tangible and intangible resources.

4.2 The Resource-Based View

To gain a deeper understanding of how the interplay between resources and capabilities creates core competencies that drive firm activities leading to competitive advantage, we turn to the **resource-based view** of the firm. This model systematically aids in identifying core competencies.⁵ As the name suggests, this model sees resources as key to superior firm performance. As Exhibit 4.4 illustrates, resources fall broadly into two categories: tangible and intangible. **Tangible resources** have physical attributes and are visible. Examples of tangible resources are labor, capital, land, buildings, plant, equipment, and supplies. **Intangible resources** have no physical attributes and thus are invisible. Examples of intangible resources are a firm's culture, its knowledge, brand equity, reputation, and intellectual property.

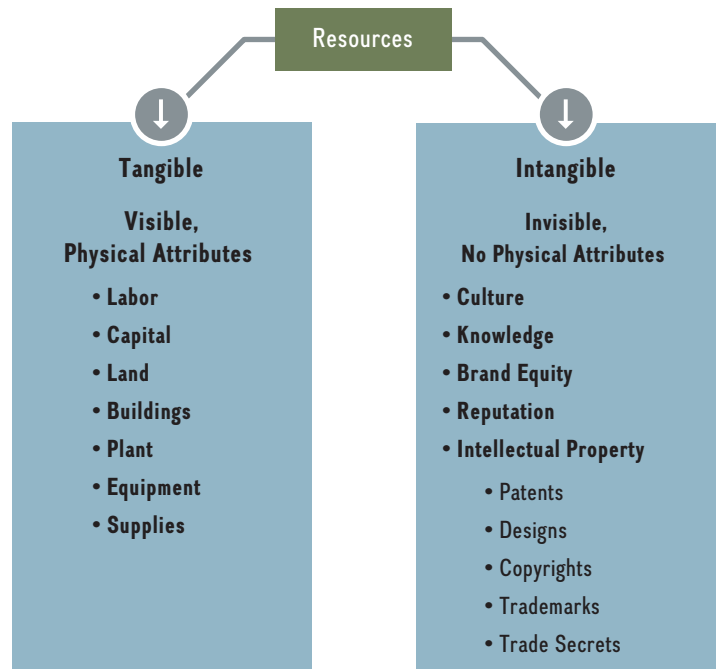
Consider Google (since 2015 a subsidiary of Alphabet, which is a holding company overseeing a diverse set of activities). Alphabet's tangible resources, valued at \$34 billion, include its headquarters (The Googleplex)⁶ in Mountain View, California, and numerous server farms (clusters of computer servers) across the globe.⁷ The Google brand, an intangible resource, is valued at roughly \$230 billion (number one worldwide)—almost seven times higher than the value of Alphabet's tangible assets.⁸

Google's headquarters provides examples of both tangible and intangible resources. The Googleplex is a piece of land with a futuristic building, and thus a tangible resource. The *location* of the company in the heart of Silicon Valley is an *intangible resource* that provides access to a valuable network of contacts and gives the company several benefits. It allows Google to tap into a large and computer-savvy work force and access graduates and knowledge spillovers from a large number of universities, which adds to Google's technical and managerial capabilities.⁹ Another benefit

LO 4-2

Compare and contrast tangible and intangible resources.

EXHIBIT 4.4 / Tangible and Intangible Resources



resource-based view A model that sees certain types of resources as key to superior firm performance.

tangible resources Resources that have physical attributes and thus are visible.

intangible resources Resources that do not have physical attributes and thus are invisible.

stems from Silicon Valley's designation as having the largest concentration of venture capital in the United States. This proximity benefits Google because venture capitalists tend to prefer local investments to ensure closer monitoring.¹⁰ Google received initial funding from the well-known venture capital firms Kleiner Perkins Caufield & Byers and Sequoia Capital, both located in Silicon Valley.

Competitive advantage is more likely to spring from intangible rather than tangible resources. Tangible assets, such as buildings or computer servers, can be bought on the open market by anyone who has the necessary cash. However, a brand name must be built, often over long periods of time. Google (founded in 1998) and Amazon.com (founded in 1994, and with a brand value of \$100 billion) accomplished their enormous brand valuations fairly quickly due to a ubiquitous internet presence, while the other companies in the global top-10 most valuable brands—Apple, Microsoft, AT&T, Facebook, Visa, Verizon, McDonald's, and IBM—took much longer to build value and have it recognized in the marketplace.¹¹

Note that the resource-based view of the firm uses the term *resource* much more broadly than previously defined. In the resource-based view of the firm, a resource includes any assets as well as any capabilities and competencies that a firm can draw upon when formulating and implementing strategy. In addition, the usefulness of the resource-based view to explain and predict competitive advantage rests upon two critical assumptions about the nature of resources, to which we turn next.

LO 4-3

Evaluate the two critical assumptions behind the resource-based view.

resource heterogeneity

Assumption in the resource-based view that a firm is a bundle of resources and capabilities that differ across firms.

TWO CRITICAL ASSUMPTIONS

Two assumptions are critical in the resource-based model: (1) *resource heterogeneity* and (2) *resource immobility*.¹² What does this mean? In the resource-based view, a firm is assumed to be a unique bundle of resources, capabilities, and competencies. The first critical assumption—**resource heterogeneity**—comes from the insight that bundles of resources, capabilities, and competencies differ across firms. This insight ensures that analysts look more critically at the resource bundles of firms competing in the *same* industry (or even the same strategic group), because each bundle is unique to some extent. For example, Southwest Airlines (SWA) and Alaska Airlines both compete in the same strategic group (low-cost, point-to-point airlines, see Exhibit 3.7). But they draw on different resource bundles. SWA's employee productivity tends to be higher than that of Alaska Airlines, because the two companies differ along human and organizational resources. At SWA, job descriptions are informal and employees pitch in to “get the job done.” Pilots may help load luggage to ensure an on-time departure; flight attendants clean airplanes to help turn them around at the gate within 15 minutes from arrival to departure. This allows SWA to keep its planes flying for longer and lowers its cost structure, savings that SWA passes on to passengers in lower ticket prices.

resource immobility

Assumption in the resource-based view that a firm has resources that tend to be “sticky” and that do not move easily from firm to firm.

The second critical assumption—**resource immobility**—describes the insight that resources tend to be “sticky” and don't move easily from firm to firm. Because of that stickiness, the resource differences that exist between firms are difficult to replicate and, therefore, can last for a long time. For example, SWA has enjoyed a sustained competitive advantage, allowing it to outperform its competitors over several decades. That resource difference is not due to a lack of imitation attempts, though. Continental and Delta both attempted to copy SWA, with Continental Lite and Song airline offerings, respectively. Neither airline, however, was able to successfully imitate the resource bundles and firm capabilities that make SWA unique. Combined, these insights tell us that resource bundles differ across firms, and such differences can persist for long periods. These two assumptions about resources are critical to explaining superior firm performance in the resource-based model.

Note, by the way, that the critical assumptions of the resource-based model are fundamentally different from the way in which a firm is viewed in the perfectly competitive industry structure introduced in Chapter 3. In perfect competition, all firms have access to the *same* resources and capabilities, ensuring that any advantage that one firm has will be short-lived. That is, when resources are freely available and mobile, competitors can move quickly to acquire resources that are utilized by the current market leader. Although some commodity markets approach this situation, most other markets include firms whose resource endowments differ. The resource-based view, therefore, delivers useful insights to managers about how to formulate a strategy that will enhance the chances of gaining a competitive advantage.

THE VRIO FRAMEWORK

Our tool for evaluating a firm's resource endowments is a framework that answers the question of what resource attributes underpin competitive advantage. This framework is implied in the resource-based model, identifying certain *types of resources* as key to superior firm performance.¹³ For a resource to be the basis of a competitive advantage, it must be

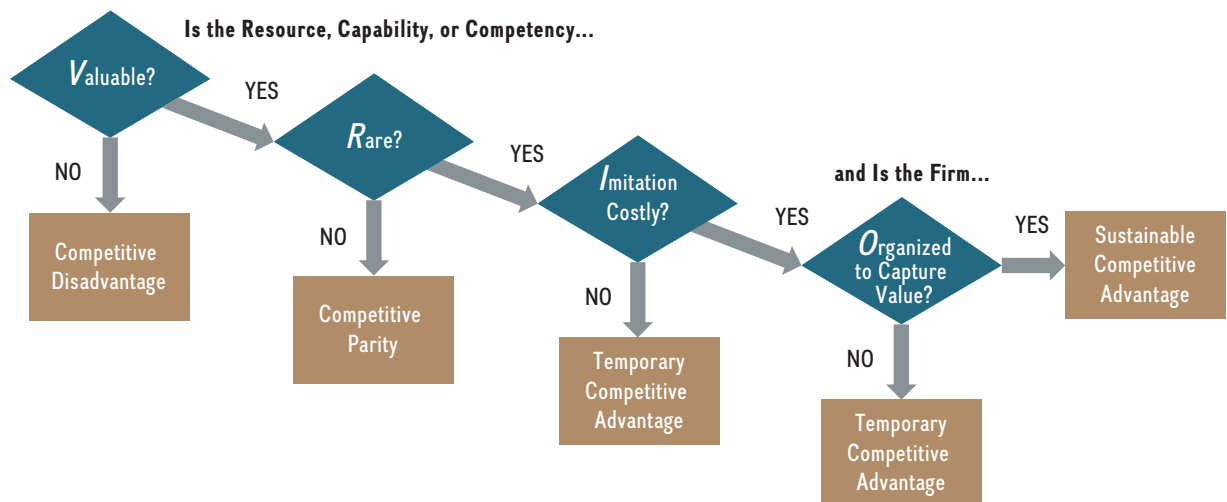
- Valuable,
- Rare, and costly to
- Imitate. And finally, the firm itself must be
- Organized to capture the value of the resource.

Following the lead of Jay Barney, one of the pioneers of the resource-based view of the firm, we call this model the **VRIO framework**.¹⁴ According to this model, a firm can gain and sustain a competitive advantage only when it has resources that satisfy all of the VRIO criteria. Keep in mind that resources in the VRIO framework are broadly defined to include any assets *as well as* any capabilities and competencies that a firm can draw upon when formulating and implementing strategy. So to some degree, this presentation of the VRIO model summarizes all of our discussion in the chapter so far.

Exhibit 4.5 captures the VRIO framework in action. You can use this decision tree to decide if the resource, capability, or competency under consideration fulfills the VRIO

VRIO framework A theoretical framework that explains and predicts firm-level competitive advantage.

EXHIBIT 4.5 / Applying the VRIO Framework to Reveal Competitive Advantage



requirements. As you study the following discussion of each of the VRIO attributes, you will see that the attributes accumulate. If the answer is “yes” four times to the attributes listed in the decision tree, only then is the resource in question a core competency that underpins a firm’s sustainable competitive advantage.

LO 4-4

Apply the VRIO framework to assess the competitive implications of a firm’s resources.

valuable resource One of the four key criteria in the VRIO framework. A resource is valuable if it helps a firm exploit an external opportunity or offset an external threat.

rare resource One of the four key criteria in the VRIO framework. A resource is rare if the number of firms that possess it is less than the number of firms it would require to reach a state of perfect competition.

costly-to-imitate resource One of the four key criteria in the VRIO framework. A resource is costly to imitate if firms that do not possess the resource are unable to develop or buy the resource at a comparable cost.

VALUABLE. A **valuable resource** is one that enables the firm to exploit an external opportunity or offset an external threat. This has a positive effect on a firm’s competitive advantage. In particular, a valuable resource enables a firm to increase its economic value creation ($V - C$). Revenues rise if a firm is able to increase the perceived value of its product or service in the eyes of consumers by offering superior design and adding attractive features (assuming costs are not increasing). Production costs, for example, fall if the firm is able to put an efficient manufacturing process and tight supply chain management in place (assuming perceived value is not decreasing). Beats Electronics’ ability to design and market premium headphones that bestow a certain air of coolness upon wearers is a valuable resource. The profit margins for Beats designer headphones are astronomical: The production cost for its headphones is estimated to be no more than \$15, while they retail for \$150 to \$450, with some special editions over \$1,000. Thus, Beats’ competency in designing and marketing premium headphones is a valuable resource in the VRIO framework.

RARE. A resource is **rare** if only one or a few firms possess it. If the resource is common, it will result in perfect competition where no firm is able to maintain a competitive advantage (see discussion in Chapter 3). A resource that is valuable but not rare can lead to competitive parity at best. A firm is on the path to competitive *advantage* only if it possesses a valuable resource that is also rare. Beats Electronics’ ability and reach in product placement and celebrity endorsements that build its coolness factor are certainly rare. No other brand in the world, not even Apple or Nike, has such a large number of celebrities from music, movies, and sports using its product in public. Thus, this resource is not only valuable but also rare.

COSTLY TO IMITATE. A resource is **costly to imitate** if firms that do not possess the resource are unable to develop or buy the resource at a reasonable price. If the resource in question is valuable, rare, and costly to imitate, then it is an internal strength and a core competency. If the firm’s competitors fail to duplicate the strategy based on the valuable, rare, and costly-to-imitate resource, then the firm can achieve a temporary competitive advantage.

Beats’ core competency in establishing a brand that communicates coolness is built upon the intuition and feel for music and cultural trends of Dr. Dre, one of music’s savviest marketing minds. Although the sound quality of Beats headphones is good enough, they mainly sell as a fashion accessory for their coolness factor and brand image. Because its creator Dr. Dre relies on gut instinct in making decisions rather than market research, this resource is costly to imitate. Even if a firm wanted to copy Beats’ core competency—how would it go about it? The music and trend-making talent as well as the social capital of Dr. Dre and Jimmy Iovine, two of the best-connected people in the music industry, might be impossible to replicate. Even Apple with its deep talent pool decided not to build its own line of premium headphones but rather opted to acquire Beats Electronics’ line for \$3 billion, and to put employment contracts in place that make Dr. Dre and Jimmy Iovine senior executives at Apple Inc. The combination of the three resource attributes ($V + R + I$) has allowed Beats Electronics to enjoy a competitive advantage (see Exhibit 4.5).

A firm that enjoys a competitive advantage, however, attracts significant attention from its competitors. They will attempt to negate a firm’s resource advantage by directly imitating the resource in question (*direct imitation*) or through working around it to provide a comparable product or service (*substitution*).

Direct Imitation. We usually see direct imitation, as a way to copy or imitate a valuable and rare resource, when firms have difficulty protecting their advantage. (We discuss barriers to imitation shortly.) Direct imitation is swift if the firm is successful and intellectual property (IP) protection such as patents or trademarks, for example, can be easily circumvented.

Crocs, the maker of the iconic plastic clog, fell victim to direct imitation. Launched in 2002 as a spa shoe at the Fort Lauderdale, Florida, boat show, Crocs experienced explosive growth, selling millions of pairs each year and reaching over \$650 million in revenue in 2008. Crocs are worn by people in every age group and walk of life, including celebrities Sergey Brin, Matt Damon, Heidi Klum, Adam Sandler, and even Kate Middleton, the Duchess of Cambridge. To protect its unique shoe design, the firm owns several patents. Given Crocs' explosive growth, however, numerous cheap imitators have sprung up to copy the colorful and comfortable plastic clog. Despite the patents and celebrity endorsements, other firms were able to copy the shoe, taking a big bite into Crocs' profits. Indeed, Crocs' share price plunged from a high of almost \$75 to less than \$1 in just 13 months.¹⁵

This example illustrates that competitive advantage cannot be sustained if the underlying capability can easily be replicated and can thus be *directly imitated*. Competitors simply created molds to imitate the shape, look, and feel of the original Crocs shoe. Any competitive advantage in a fashion-driven industry, moreover, is notoriously short-lived if the company fails to continuously innovate or build such brand recognition that imitators won't gain a foothold in the market. Crocs was more or less a "one-trick pony."

Beats Electronics, on the other hand, created an ecosystem of hardware (Beats by Dr. Dre) and software (Beats Music) that positively reinforce one another. Beats by Dr. Dre are the installed base that drives demand for Beats Music (now called Apple Music). As Apple Music's music streaming and celebrity-curated playlists become more popular, demand for Beats headphones further increases. With increasing demand, Apple Music services also become more valuable as its proprietary algorithms have more data to work with. Continuous innovation by churning out new headphone designs combined with the unique coolness factor of Dr. Dre make direct imitation attempts difficult.

Substitution. The second avenue of imitation for a firm's valuable and rare resource is through *substitution*. This is often accomplished through *strategic equivalence*. Take the example of Jeff Bezos launching and developing Amazon.com.¹⁶ Before Amazon's inception, the retail book industry was dominated by a few large chains and many independent mom-and-pop bookstores. As the internet was emerging in the 1990s, Bezos was looking for options in online retail. He zeroed in on books because of their non-differentiated commodity nature and easiness to ship. In purchasing a printed book online, customers knew exactly what they would be shipped, because the products were identical, whether sold online or in a brick-and-mortar store. The only difference was the mode of transacting and delivery. Taking out the uncertainty of online retailing to some extent made potential customers more likely to try this new way of shopping.

The emergence of the internet allowed Bezos to come up with a new distribution system that negated the need for retail stores and thus high real-estate costs. Bezos' new business model of ecommerce not only substituted for the traditional fragmented supply chain in book retailing, but also allowed Amazon to offer lower prices due to its lower operating costs. Amazon uses a strategic equivalent substitute to satisfy a customer need previously met by brick-and-mortar retail stores.



Tiffany & Co. has developed a core competency—elegant jewelry design and craftsmanship delivered through a superior customer experience—that is valuable, rare, and costly for competitors to imitate. The company vigorously protects its trademarks, including its Tiffany Blue Box, but it never trademarked the so-called Tiffany setting for diamond rings, used now by many jewelers. The term has been co-opted for advertising by other retailers (including Costco), which now maintain it is a generic term commonly used in the jewelry industry.

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Combining Imitation and Substitution. In some instances, firms are able to combine direct imitation and substitution when attempting to mitigate the competitive advantage of a rival. With its Galaxy line of smartphones, Samsung has been able to imitate successfully the look and feel of Apple's iPhones. Samsung's Galaxy smartphones use Google's Android operating system and apps from Google Play as an alternative to Apple's iOS and iTunes Store. Samsung achieved this through a combination of *direct imitation* (look and feel) and *substitution* (using Google's mobile operating system and app store).¹⁷

More recently Amazon has opened a new chapter in its competitive moves by its acquisition of the brick-and-mortar Whole Foods in 2017. As we will see in ChapterCase 8, Amazon's entry into high-end groceries involves both imitation and substitution.

ORGANIZED TO CAPTURE VALUE. The final criterion of whether a rare, valuable, and costly-to-imitate resource can form the basis of a sustainable competitive advantage depends on the firm's internal structure. To fully exploit the competitive potential of its resources, capabilities, and competencies, a firm must be **organized to capture value**—that is, it must have in place an effective organizational structure and coordinating systems. (We will study organizational design in detail in Chapter 11.)

Before Apple or Microsoft had any significant share of the personal computer market, Xerox's Palo Alto Research Center (PARC) invented and developed an early word-processing application, the graphical user interface (GUI), the Ethernet, the mouse as a pointing device, and even the first personal computer. These technology breakthroughs laid the foundation of the desktop-computing industry.¹⁸ Xerox's invention competency built through a unique combination of resources and capabilities was clearly valuable, rare, and costly to imitate with the potential to create a competitive advantage.

Due to a lack of appropriate organization, however, Xerox failed to appreciate and exploit the many breakthroughs made by PARC in computing software and hardware. Why? Because the innovations did not fit within the Xerox business focus at the time. Under pressure in its core business from Japanese low-cost competitors, Xerox's top management was busy pursuing innovations in the photocopier business. Xerox was not organized to appreciate the competitive potential of the valuable, rare, and inimitable resources generated at PARC, if not in the photocopier field. Such organizational problems were exacerbated by geography: Xerox headquarters is on the East Coast in Norwalk, Connecticut, across the country from PARC on the West Coast in Palo Alto, California.¹⁹ Nor did it help that development engineers at Xerox headquarters had a disdain for the scientists engaging in basic research at PARC. In the meantime, both Apple and Microsoft developed operating systems, graphical user interfaces, and application software.

If a firm is not effectively organized to exploit the competitive potential of a valuable, rare, and costly-to-imitate (VRI) resource, the best-case scenario is a temporary competitive advantage (see Exhibit 4.5). In the case of Xerox, where management was not supportive of the resource, even a temporary competitive advantage would not be realized even though the resource meets the VRI requirements.

In summary, for a firm to gain and sustain a competitive advantage, its resources and capabilities need to interact in such a way as to create unique core competencies (see Exhibit 4.3). Ultimately, though, only a few competencies may turn out to be those *specific* core competencies that fulfill the VRIO requirements.²⁰ A company cannot do everything equally well and must carve out a unique strategic position for itself, making necessary trade-offs.²¹ Strategy Highlight 4.1 demonstrates application of the VRIO framework.

organized to capture value One of the four key criteria in the VRIO framework. The characteristic of having in place an effective organizational structure, processes, and systems to fully exploit the competitive potential of the firm's resources, capabilities, and competencies.

Strategy Highlight 4.1

Applying VRIO: The Rise and Fall of Groupon

After graduating with a degree in music from Northwestern University, Andrew Mason spent a couple of years as a web designer. In 2008, the then 27-year-old founded Groupon, a daily-deal website that connects local retailers and other merchants to consumers by offering goods and services at a discount. Groupon creates marketplaces by bringing the brick-and-mortar world of local commerce onto the internet. The company basically offers a “group-coupon.” If more than a predetermined number of Groupon users sign up for the offer, the deal is extended to all Groupon users. For example, a local spa may offer a massage for \$40 instead of the regular \$80. If more than say 10 people sign up, the deal becomes reality. The users prepay \$40 for the coupon, which Groupon splits 50-50 with the local merchant. Inspired by how Amazon.com has become the global leader in e-commerce, Mason’s strategic vision for Groupon was *to be the global leader in local commerce*.

Measured by its explosive growth, Groupon became one of the most successful recent internet startups, with over 260 million subscribers and serving more than 500,000 merchants in the United States and some 50 countries. Indeed, Groupon’s success attracted a \$6 billion buyout offer by Google in early 2011, which Mason declined. In November 2011, Groupon held a successful initial public offering (IPO), valued at more than \$16 billion with a share price of over \$26. But a year later, Groupon’s share price had fallen 90 percent to just \$2.63, resulting in a market cap of less than \$1.8 billion. In early 2013, Mason posted a letter for Groupon employees on the web, arguing that it would leak anyway, stating, “After four and a half intense and wonderful years as CEO of Groupon, I’ve decided that I’d like to spend more time with my family. Just kidding—I was fired today.”

Although Groupon is still in business, it is just one competitor among many, and not a market leader. What went wrong? The implosion of Groupon’s market value can be explained using the VRIO framework. Its competency to drum up more business for local retailers by offering lower prices for its users was certainly *valuable*. Before Groupon, local merchants used online and classified ads, direct mail, yellow pages, and other venues to reach customers. Rather than using one-way communication, Groupon facilitates the meeting of supply and demand in local markets. When Groupon launched, such local

market-making competency was also *rare*. Groupon, with its first-mover advantage, seemed able to use technology in a way so valuable and rare it prompted Google’s buyout offer. But was it costly to imitate? Not so much.

The multibillion-dollar Google offer spurred potential competitors to reproduce Groupon’s business model. They discovered that Groupon was more of a sales company than a tech venture, despite perceptions to the contrary. To target and fine-tune its local deals, Groupon relies heavily on human labor to do the selling. Barriers to entry in this type of business are nonexistent because Groupon’s competency is built more on a tangible resource (labor) than on an intangible one (proprietary technology). Given that Groupon’s valuable and rare competency was *not hard to imitate*, hundreds of new ventures (so-called Groupon clones) rushed in to take advantage of this opportunity. Existing online giants such as Google, Amazon (via LivingSocial), and Facebook also moved in. The spurned Google almost immediately created its own daily-deal version with Google Offers.

Also, note that the ability to imitate a rare and valuable resource is directly linked to barriers of entry, which is one of the key elements in Porter’s five forces model (*threat of new entrants*). This relationship allows linking internal analysis using the resource-based view to external analysis with the five forces model, which also would have predicted low industry profit potential given low or no barriers to entry.

To make matters worse, these Groupon clones are often able to better serve the needs of local markets and specific population groups. Some daily-deal sites focus only on a specific geographic area. As an example, Conejo Deals meets the needs of customers and retailers in Southern California’s Conejo Valley, a cluster of suburban communities. These hyper-local sites tend to have much deeper relationships and expertise with merchants in their specific areas. Since they are mostly matching local customers with local businesses, moreover, they tend to foster more repeat business than the one-off bargain hunters that use Groupon (based in Chicago). In addition, some daily-deal sites often target specific groups. They have greater expertise in matching their users with local retailers (e.g., Daily Pride serving LGBT communities; Black Biz Hookup serving African-American business owners and operators; Jdeal, a Jewish group-buying site in New York City; and so on).

(continued)

“Finding your specific group” or “going hyper local” allows these startups to increase the perceived value added for their users over and above what Groupon can offer. Although Groupon aspires to be the *global leader*, there is really no advantage to global scale in serving local markets. This is because daily-deal sites are best suited to market *experience goods*, such as haircuts at a local barber shop or a meal in a specific Thai restaurant. The quality of these goods

and services cannot be judged unless they are consumed. Creation of experience goods and their consumption happens in the *same geographic space*.

Once imitated, Groupon’s competency to facilitate local commerce using an internet platform was neither valuable nor rare. As an application of the VRIO model would have predicted, Groupon’s competitive advantage as a first mover would only be temporary at best (see Exhibit 4.5).²²

LO 4-5

Evaluate different conditions that allow a firm to sustain a competitive advantage.

isolating mechanisms

Barriers to imitation that prevent rivals from competing away the advantage a firm may enjoy.

ISOLATING MECHANISMS: HOW TO SUSTAIN A COMPETITIVE ADVANTAGE

Although VRIO resources can lay the foundation of a competitive advantage, no competitive advantage can be sustained indefinitely.²³ Several conditions, however, can offer some protection to a successful firm by making it more difficult for competitors to imitate the resources, capabilities, or competencies that underlie its competitive advantage. *Barriers to imitation* are important examples of **isolating mechanisms** because they prevent rivals from competing away the advantage a firm may enjoy; they include:²⁴

- Better expectations of future resource value.
- Path dependence.
- Causal ambiguity.
- Social complexity.
- Intellectual property (IP) protection.

This link ties isolating mechanisms directly to one of the criteria in the resource-based view to assess the basis of competitive advantage: costly (or difficult) to imitate. If one, or any combination, of these isolating mechanisms is present, a firm may strengthen its basis for competitive advantage, increasing its chance to be sustainable over a longer period of time.

BETTER EXPECTATIONS OF FUTURE RESOURCE VALUE. Sometimes firms can acquire resources at a low cost, which can lay the foundation for a competitive advantage later when expectations about the future of the resource turn out to be more accurate than those held by competitors. Better expectations of the future value of a resource allows a firm to gain a competitive advantage. If such better expectations can be systematically repeated over time, it may help in sustaining a competitive advantage.

A real estate developer illustrates the role that the future value of a resource can play. She must decide when and where to buy land for future development. Her firm may gain a competitive advantage if she buys a parcel of land for a low cost in an undeveloped rural area 40 miles north of San Antonio, Texas—in anticipation that it will increase in value with shifting demographics. Let’s assume, several years later, that an interstate highway is built near her firm’s land. With the highway, suburban growth explodes as many new neighborhoods and shopping malls are built. Her firm is now able to develop this particular piece of property to build high-end office or apartment buildings. The value creation far exceeds the cost, and her firm gains a competitive advantage. The resource has suddenly become valuable, rare, and costly to imitate, gaining the developer’s firm a competitive advantage.

Other developers could have bought the land, but once the highway was announced, the cost of the developer's land and that of adjacent land would have risen drastically, reflecting the new reality and thus negating any potential for competitive advantage. The developer had better expectations than her competitors of the future value of the resource, in this case the land she purchased. If this developer can repeat such "better expectations" over time in a more or less systematic fashion, her firm is likely to have a sustainable competitive advantage. If she cannot, she was simply lucky. Although luck can play a role in gaining an initial competitive advantage, it is not a basis for a sustainable competitive advantage.

PATH DEPENDENCE. Path dependence describes a process in which the options one faces in a current situation are limited by decisions made in the past.²⁵ Often, early events—sometimes even random ones—have a significant effect on final outcomes.

The U.S. carpet industry provides an example of path dependence.²⁶ Roughly 85 percent of all carpets sold in the United States and almost one-half of all carpets sold worldwide come from carpet mills located within 65 miles of one city: Dalton, Georgia. While the U.S. manufacturing sector has suffered in recent decades, the carpet industry has flourished. Companies not clustered near Dalton face a disadvantage because they cannot readily access the required know-how, skilled labor, suppliers, low-cost infrastructure, and so on needed to be competitive.

But why Dalton? Two somewhat random events combined. First, the boom after World War II drew many manufacturers South to escape restrictions placed upon them in the North, such as higher taxation or the demands of unionized labor. Second, technological progress allowed industrial-scale production of tufted textiles to be used *as substitutes for the more expensive wool*. This innovation emerged in and near Dalton. This historical accident explains why today almost all U.S. carpet mills are located in a relatively small region, including world leaders Shaw Industries and Mohawk Industries.

Path dependence also rests on the notion that time cannot be compressed at will. While management can compress resources such as labor and R&D into a shorter period, the push will not be as effective as when a firm spreads out its effort and investments over a longer period. Trying to achieve the same outcome in less time, even with higher investments, tends to lead to inferior results, due to *time compression diseconomies*.²⁷

Consider GM's problems in providing a competitive alternative to the highly successful Toyota Prius, a hybrid electric vehicle. Its problems highlight path dependence and time compression issues. The California Air Resource Board (CARB) in 1990 passed a mandate for introducing zero-emissions cars, which stipulated that 10 percent of new vehicles sold by carmakers in the state must have zero emissions by 2003. This mandate not only accelerated research in alternative energy sources for cars, but also led to the development of the first fully electric production car, GM's EV1. GM launched the car in California and Arizona in 1996. Competitive models followed, with the Toyota RAV EV and the Honda EV. In this case, regulations in the legal environment fostered innovation in the automobile industry (see discussion of PESTEL forces in Chapter 3).

Companies not only feel the nudge of forces in their environment but can also push back. The California mandate on zero emissions, for example, did not stand.²⁸ Several stakeholders, including the car and oil companies, fought it through lawsuits and other actions. CARB ultimately gave in to the pressure and abandoned its zero-emissions mandate. When the mandate was revoked, GM recalled and destroyed its EV1 electric vehicles and terminated its electric-vehicle program. This decision turned out to be a strategic error that would haunt GM a decade or so later. Although GM was the leader among car companies in electric vehicles in the mid-1990s, it did not have a competitive model to counter the Toyota Prius when its sales took off in the early 2000s.

path dependence

A situation in which the options one faces in the current situation are limited by decisions made in the past.

The Chevy Volt (a plug-in hybrid), GM's first major competition to the Prius, was delayed by over a decade because GM had to start its electric-vehicle program basically from scratch. While GM sold about 50,000 Chevy Volts worldwide, Toyota sold over 6 million Prius cars. Moreover, when Nissan introduced its all-electric Leaf in 2010, GM did not have an all-electric vehicle in its lineup. In the meantime, Nissan sold over 250,000 Leafs worldwide.

Not having an adequate product lineup during the early 2000s, GM's U.S. market share dropped below 20 percent in 2009 (from over 50 percent a few decades earlier), the year it filed for bankruptcy. GM subsequently reorganized under Chapter 11 of the U.S. bankruptcy code, and relisted on the New York Stock Exchange in 2010.

Collaborating with LG Corp. of Korea, GM introduced the Chevy Bolt, an all-electric vehicle in 2017.²⁹ Although some of its features, such as a 230-mile range on a single charge, look attractive, it remains to be seen if the Chevy Bolt will do well in the marketplace. This is because competition did not stand still either. In the meantime, Tesla (featured in ChapterCase 1) is hoping that its new Model 3 will take the mass market of electric cars by storm, as it is priced at some \$35,000, much lower than its luxury cars (Model S and Model X).

One important take-away here is that once the train of new capability development has left the station, it is hard to jump back on because of path dependence. Moreover, firms cannot compress time at will; indeed, learning and improvements must take place over time, and existing competencies must constantly be nourished and upgraded.

Strategic decisions generate long-term consequences due to path dependence and time-compression diseconomies; they are not easily reversible. A competitor cannot imitate or create core competencies quickly, nor can one buy a reputation for quality or innovation on the open market. These types of valuable, rare, and costly-to-imitate resources, capabilities, and competencies must be built and organized effectively over time, often through a painstaking process that frequently includes learning from failure.

causal ambiguity

A situation in which the cause and effect of a phenomenon are not readily apparent.

CAUSAL AMBIGUITY. Causal ambiguity describes a situation in which the cause and effect of a phenomenon are not readily apparent. To formulate and implement a strategy that enhances a firm's chances of gaining and sustaining a competitive advantage, managers need to have a hypothesis or theory of how to compete. A hypothesis is simply a specific statement that proposes an explanation of a phenomenon (such as competitive advantage), while a theory is a more generalized explanation of what causes what, and why. This implies that managers need to have some kind of understanding about what causes superior or inferior performance, and why. Comprehending and explaining the underlying reasons of observed phenomena is far from trivial, however. Everyone can see that Apple has had several hugely successful innovative products such as the iMac, iPod, iPhone, and iPad, combined with its hugely popular iTunes services, leading to a decade of a sustainable competitive advantage. These successes stem from Apple's set of *V*, *R*, *I*, and *O* core competencies that supports its ability to continue to offer a variety of innovative products and to create an ecosystem of products and services.

A deep understanding, however, of exactly *why* Apple has been so successful is very difficult. Even Apple's managers may not be able to clearly pinpoint the sources of their success. Is it the visionary role that the late Steve Jobs played? Is it the rare skills of Apple's uniquely talented design team around Jonathan Ive? Is it the timing of the company's product introductions? Is it Apple CEO Tim Cook who adds superior organizational skills and puts all the pieces together when running the day-to-day operations? Or is it a combination of these factors? If the link between cause and effect is ambiguous for Apple's managers, it is that much more difficult for others seeking to copy a valuable resource, capability, or competency.

SOCIAL COMPLEXITY Social complexity describes situations in which different social and business systems interact. There is frequently no causal ambiguity as to how the *individual* systems such as supply chain management or new-product development work in isolation. They are often managed through standardized business processes such as Six Sigma or ISO 9000. Social complexity, however, emerges when two or more such systems are *combined*. Copying the emerging complex social systems is difficult for competitors because neither direct imitation nor substitution is a valid approach. The interactions between different systems create too many possible permutations for a system to be understood with any accuracy. The resulting social complexity makes copying these systems difficult, if not impossible, resulting in a valuable, rare, and costly-to-imitate resource that the firm is organized to exploit.

Look at it this way. A group of three people has three relationships, connecting every person directly with one another. Adding a fourth person to this group *doubles* the number of direct relationships to six. Introducing a fifth person increases the number of relationships to 10.³⁰ This gives you some idea of how complexity might increase when we combine different systems with many different parts.

In reality, firms may manage thousands of employees from all walks of life. Their interactions within the firm's processes, procedures, and norms make up its culture. Although an observer may conclude that Zappos' culture, with its focus on autonomous teams in a flat hierarchy to provide superior customer service, might be the basis for its competitive advantage, engaging in reverse social engineering to crack Zappos' code of success might be much more difficult. Moreover, an organizational culture that works for online retailer Zappos, led by CEO and chief happiness officer Tony Hsieh, might seed havoc for an aerospace and defense company such as Lockheed Martin, led by CEO Marillyn Hewson. This implies that one must understand competitive advantage within its organizational and industry context. Looking at individual elements of success without taking social complexity into account is a recipe for inferior performance, or worse.

INTELLECTUAL PROPERTY PROTECTION. Intellectual property (IP) protection is a critical intangible resource that can also help sustain a competitive advantage. The five major forms of IP protection are:³¹

- Patents
- Designs
- Copyrights
- Trademarks
- Trade secrets

The intent of IP protection is to prevent others from copying legally protected products or services. In many knowledge-intensive industries that are characterized by high research and development (R&D) costs, such as smartphones and pharmaceuticals, IP protection provides not only an incentive to make these risky and often large-scale investments in the first place, but also affords a strong isolating mechanism that is critical to a firm's ability to capture the returns to investment. Although the initial investment to create the first version of a new product or service is quite high in many knowledge-intensive industries, the *marginal cost* (i.e., the cost to produce the next unit) after initial invention is quite low. For example, Microsoft spends billions of dollars to develop a new version of its Windows operating system; once completed, the cost of the next "copy" is close to zero because it is just software code distributed online in digital form. In a similar fashion, the costs of developing a new prescription drug, a process often taking more than a decade, are estimated to be over \$2.5 billion.³² Rewards to IP-protected products or services, however, can be high.



Marillyn Hewson is CEO of Lockheed Martin, a global player in aerospace, defense, security, and advanced technology. Facing ever more complex challenges, such firms only thrive with a strong organization and a powerful CEO like Hewson. ©Bloomberg/Getty Images

social complexity

A situation in which different social and business systems interact with one another.

intellectual property (IP) protection

A critical intangible resource that can provide a strong isolating mechanism, and thus help to sustain a competitive advantage.

During a little over 14 years on the market, Pfizer's Lipitor, the world's best-selling drug, accumulated over \$125 billion in sales.³³

IP protection can make direct imitation attempts difficult, if not outright illegal. A U.S. court, for example, has found that Samsung infringed in some of its older models on Apple's patents and awarded some \$600 million in damages.³⁴ In a similar fashion, Dr. Dre attracted significant attention and support from other artists in the music industry when he sued Napster, an early online music file-sharing service, and helped shut it down in 2001 because of copyright infringements.

IP protection does not last forever, however. Once the protection has expired the invention can be used by others. Patents, for example, usually expire 20 years after a patent is filed with the U.S. Patent and Trademark Office. In the next few years, patents protecting roughly \$100 billion in sales of proprietary drugs in the pharmaceutical industry are set to expire. Once this happens, producers of generics (drugs that contain the same active ingredients as the original patent-protected formulation) such as Teva Pharmaceutical Industries of Israel enter the market, and prices fall drastically. Pfizer's patent on Lipitor expired in 2011. Just one year later, of the 55 million Lipitor prescriptions, 45 million (or more than 80 percent) were generics.³⁵ Drug prices fall by 20 to 80 percent once generic formulations become available.³⁶

Taken together, each of the five isolating mechanisms discussed here (or combinations thereof) allow a firm to extend its competitive advantage. Although no competitive advantage lasts forever, a firm may be able to protect its competitive advantage (even for long periods) when it has consistently better expectations about the future value of resources, when it has accumulated a resource advantage that can be imitated only over long periods of time, when the source of its competitive advantage is causally ambiguous or socially complex, or when the firm possesses strong intellectual property protection.

LO 4-6

Outline how dynamic capabilities can enable a firm to sustain a competitive advantage

4.3 The Dynamic Capabilities Perspective

A firm's external environment is rarely stable (as discussed in Chapter 3). Rather, in many industries, the pace of change is ferocious. Firms that fail to adapt their core competencies to a changing external environment not only lose a competitive advantage but may even go out of business.

We've seen the merciless pace of change in consumer electronics retailing in the United States. Once a market leader, Circuit City's core competencies were in efficient logistics and superior customer service. But the firm neglected to upgrade and hone them over time. As a consequence, Circuit City was outflanked by Best Buy and online retailer Amazon, and went bankrupt. Best Buy encountered the same difficulties competing against Amazon just a few years later. Core competencies might form the basis for a competitive advantage at one point, but as the environment changes, the very same core competencies might later turn into *core rigidities*, retarding the firm's ability to change.³⁷

A core competency can turn into a **core rigidity** if a firm relies too long on the competency without honing, refining, and upgrading as the environment changes.³⁸ Over time, the original core competency is no longer a good fit with the external environment, and it turns from an asset into a liability. Strategy Highlight 4.2 shows how Procter & Gamble failed to hone and upgrade its core competencies. As a consequence, P&G's strategy was no longer a good fit with a changing environment, leading to a competitive disadvantage.

The reason reinvesting, honing, and upgrading of resources and capabilities are so crucial to sustaining any competitive advantage is to prevent competencies from turning into

core rigidity A former core competency that turned into a liability because the firm failed to hone, refine, and upgrade the competency as the environment changed.

Strategy Highlight 4.2

When Will P&G Play to Win Again?

With revenues of some \$65 billion and business in basically every country except North Korea, Procter & Gamble (P&G) is the world's largest consumer products company. Some of its category-defining brands include Ivory soap, Tide detergent, Febreze air freshener, Crest toothpaste, and Pampers diapers. Among its many offerings, P&G has more than 20 consumer brands in its lineup that each achieve over \$1 billion in annual sales. P&G's iconic brands are a result of a clearly formulated and effectively implemented business strategy. The company pursues a differentiation strategy and attempts to create higher perceived value for its customers than its competitors by delivering products with unique features and attributes.

Creating higher perceived value generally goes along with higher product costs due to greater R&D and promotion expenses, among other things. Successful differentiators are able to command a premium price for their products, but they must also control their costs. Detailing how P&G created many market-winning brands, P&G's long-term CEO A.G. Lafley published (with strategy consultant Roger Martin) the best-selling book *Playing to Win: How Strategy Really Works* in 2013.

In recent years, however, P&G's strategic position has weakened considerably, and P&G seems to be losing rather than winning. P&G lost market share in key "product-country combinations," including beauty in the United States and oral care in China, amid an overall lackluster performance in many emerging economies. As a consequence, profits have declined. With P&G's sustained competitive disadvantage, its stock market valuation has fallen—by some \$50 billion in 2015 alone. Meanwhile, its competitors such as Unilever, Colgate-Palmolive, and Kimberly-Clark posted strong gains. Many wonder, when will P&G play to win again?

Some of P&G's problems today are the result of attempting to achieve growth via an aggressive acquisition strategy in the 2000s. Given the resulting larger P&G revenue base, future incremental revenue growth for the entire company was harder to achieve. A case in point is P&G's \$57 billion acquisition of Gillette in 2005, engineered by then-CEO Lafley. The



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value of this acquisition is now being called into question. Although Gillette dominates the retail space of the \$3 billion wet shaving industry, P&G was caught off guard by how quickly razor sales moved online. Turned off by the high prices and the inconvenience of shopping for razors in locked display cases in retail stores, consumers flocked to online options in droves. The online market for razor blades has grown from basically zero just a few years ago to \$300 million. Although this is currently only 10 percent of the overall market, the online market continues to grow rapidly. Disruptive online startups such as Dollar Shave Club and Harry's offer low-cost solutions via monthly subscription plans online.

Perhaps even more troubling is that P&G focused mainly on the U.S. market to leverage its existing competencies. Rather than inventing new category-defining products, P&G added more features to its established brands such as Olay's extra-moisturizing creams and ultra-soft and sensitive Charmin toilet paper, while raising prices. Reflecting higher value creation based on its differentiation strategy, P&G generally charges a 20 to 40 percent premium for its products in comparison to retailers' private-label and other brands. The strategic decision to focus on the domestic market, combined with incrementally adding minor features to its existing products, created serious problems for P&G.³⁹

core rigidities (see Exhibit 4.3). This ability to hone and upgrade lies at the heart of the dynamic capabilities perspective. We defined *capabilities* as the organizational and managerial skills necessary to orchestrate a diverse set of resources and to deploy them strategically. Capabilities are by nature intangible. They find their expression in a company's structure, routines, and culture.

dynamic capabilities A firm's ability to create, deploy, modify, reconfigure, upgrade, or leverage its resources in its quest for competitive advantage.

The dynamic capabilities perspective adds, as the name suggests, a *dynamic* or time element. In particular, **dynamic capabilities** describe a firm's ability to create, deploy, modify, reconfigure, upgrade, or leverage its resources over time in its quest for competitive advantage.⁴⁰ Dynamic capabilities are essential to move beyond a short-lived advantage and create a sustained competitive advantage. For a firm to sustain its advantage, any fit between its internal strengths and the external environment must be dynamic. That is, the firm must be able to change its internal resource base as the external environment changes. The goal should be to develop resources, capabilities, and competencies that create a *strategic fit* with the firm's environment. Rather than creating a static fit, the firm's internal strengths should change with its external environment in a *dynamic* fashion.

A lack of strategic fit with a changing environment created at least two problems for Procter & Gamble in recent years (see Strategy Highlight 4.2). First, following the deep recession of 2008–2009, U.S. consumers moved away from higher-priced brands, such as those offered by P&G, to lower-cost alternatives. Moreover, P&G's direct rivals in branded goods, such as Colgate-Palmolive, Kimberly-Clark, and Unilever, were faster in cutting costs and prices in response to more frugal customers. P&G also fumbled launches of reformulated products such as Tide Pods (detergent sealed in single-use pouches) and the Pantene line of shampoos and conditioners. The decline in U.S. demand hit P&G especially hard because the domestic market delivers about one-third of sales, but almost two-thirds of profits for the company. Second, by focusing on the U.S. market, P&G not only missed out on the booming growth years that the emerging economies experienced during the 2000s, but it also left these markets to its rivals. As a consequence, Colgate-Palmolive, Kimberly-Clark, and Unilever all outperformed P&G in recent years.

As a result of its sustained competitive disadvantage, P&G also had a revolving door in its executive suites. From 2013 to 2015, P&G went through three CEOs. After 30 years with P&G, the former Army Ranger Robert McDonald was appointed CEO in 2009, but was replaced in spring 2013 in the face of P&G's deteriorating performance. The company's board of directors brought back A.G. Lafley. This was an interesting choice because Lafley had previously served as P&G's CEO from 2000 to 2009, and some of the strategic decisions that led to a weakening of P&G's strategic position were made under his watch. Lafley served a second term as CEO from 2013 to 2015. In late 2015, P&G named David Taylor as the new CEO, again promoting from within, while Lafley served as executive chairman until June 2016.

To strengthen its competitive position, P&G launched two strategic initiatives. First, P&G began to refocus its portfolio on the company's 70 to 80 most lucrative product-market combinations, which are responsible for 90 percent of P&G's revenues and almost all of its profits. Some argue that P&G had become too big and spread out to compete effectively in today's dynamic marketplace. To refocus on core products such as Tide, Pampers, and Olay (these three brands account for more than 50 percent of the company's revenues), P&G has sold or plans to divest almost 100 brands in its far-flung product portfolio, including well-known brands such as Iams pet food, Duracell batteries, Wella shampoos, Clairol hair dye, and CoverGirl makeup, but mainly a slew of lesser-known brands.

Part of this strategic initiative is also to expand P&G's presence in large emerging economies. As an example, P&G launched Tide in India and Pantene shampoos in Brazil. Moreover, P&G began to leverage its Crest brand globally, to take on Colgate-Palmolive's global dominance in toothpaste. Yet, the relatively strong dollar in recent years is hurting P&G's international results. Second, P&G implemented strict cost-cutting measures through eliminating all spending not directly related to selling. As part of its cost-cutting initiative, P&G also eliminated thousands of jobs.

The goal of the two strategic initiatives is to increase the perceived value of P&G's brands in the minds of the consumer, while lowering production costs. The combined effort should—if successful—increase P&G's economic value creation ($V - C$). The hope is that P&G's revised

business strategy would strengthen its strategic position and help it achieve a better strategic fit with the new environment. This should increase the likelihood that P&G can achieve a competitive advantage again. Through a number of investments in its intangible resource base, P&G is upgrading its dynamic capabilities, which had been neglected for a number of years as the consumer-products company failed to change with a changing environment.

Not only do dynamic capabilities allow firms to adapt to changing market conditions, but they also enable firms to *create market changes* that can strengthen their strategic position. These market changes implemented by proactive firms introduce altered circumstances, to which more reactive rivals might be forced to respond.

Apple's dynamic capabilities allowed it to redefine the markets for mobile devices and computing, in particular in music, smartphones, and media content. For the portable music market through its iPod and iTunes store, Apple generated environmental change to which Sony and others had to respond. With its iPhone, Apple redefined the market for smartphones, again creating environmental change to which competitors such as Samsung, BlackBerry, and Google (with its Motorola Mobility unit) needed to respond. Apple's introduction of the iPad redefined the media and tablet computing market, forcing competitors such as Amazon and Microsoft to respond. With the introduction of the Apple Watch it is attempting to shape the market for computer wearables in its favor. Dynamic capabilities are especially relevant for surviving and competing in markets that shift quickly and constantly, such as the high-tech space in which firms such as Apple, Google, Microsoft, and Amazon compete.

In the **dynamic capabilities perspective**, competitive advantage is the outflow of a firm's capacity to modify and leverage its resource base in a way that enables it to gain and sustain competitive advantage in a constantly changing environment. Given the accelerated pace of technological change, in combination with deregulation, globalization, and demographic shifts, dynamic markets today are the rule rather than the exception. As a response, a firm may create, deploy, modify, reconfigure, or upgrade resources so as to provide value to customers and/or lower costs in a dynamic environment. The essence of this perspective is that competitive advantage is not derived from static resource or market advantages, but from a *dynamic reconfiguration* of a firm's resource base.

One way to think about developing dynamic capabilities and other intangible resources is to distinguish between resource stocks and resource flows.⁴¹ In this perspective, **resource stocks** are the firm's current level of intangible resources. **Resource flows** are the firm's level of investments to maintain or build a resource. A helpful metaphor to explain the differences between resource stocks and resource flows is a bathtub that is being filled with water (see Exhibit 4.6).⁴² The amount of water in the bathtub indicates a company's level of a specific *intangible resource stock*—such as its dynamic capabilities, new-product development, engineering expertise, innovation capability, reputation for quality, and so on.⁴³

Intangible resource stocks are built through investments over time. These resource flows are represented in the drawing by the different faucets, from which water flows into the tub. These faucets indicate investments the firm can make in different intangible resources. Investments in building an innovation capability, for example, differ from investments made in marketing expertise. Each investment flow would be represented by a different faucet.

How fast a firm is able to build an intangible resource—how fast the tub fills—depends on how much water comes out of the faucets and how long the faucets are left open. Intangible resources are built through continuous investments and experience over time. Organizational learning also fosters the increase of intangible resources. Many intangible resources, such as IBM's expertise in cognitive computing, take a long time to build. IBM's quest for cognitive computing began in 1997 after its Deep Blue computer (based on artificial intelligence) beat reigning chess champion Garry Kasparov. It has invested close to \$25 billion to build a deep capability in cognitive computing with the goal to take advantage of business opportunities in big data and analytics. Its efforts were publicized when its

dynamic capabilities perspective A model that emphasizes a firm's ability to modify and leverage its resource base in a way that enables it to gain and sustain competitive advantage in a constantly changing environment.

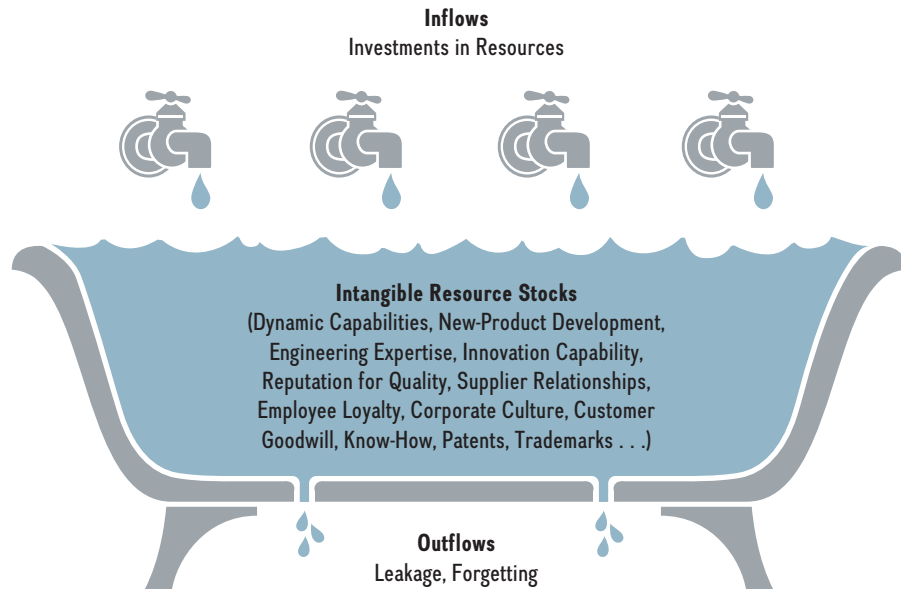
resource stocks The firm's current level of intangible resources.

resource flows The firm's level of investments to maintain or build a resource.

EXHIBIT 4.6 /

The Bathtub Metaphor: The Role of Inflows and Outflows in Building Stocks of Intangible Resources

SOURCE: Figure based on metaphor used in I. Dierickx and K. Cool (1989), "Asset stock accumulation and sustainability of competitive advantage," *Management Science* 35: 1504–1513.



Watson, a supercomputer capable of answering questions posed in natural language, went up against 74-time *Jeopardy!* quiz show champion Ken Jennings and won. Watson has demonstrated its skill in many professional areas where deep domain expertise is needed when making decisions in more or less real time: a wealth manager making investments, a doctor working with a cancer patient, an attorney working on a complex case, or even a chef in a five-star restaurant creating a new recipe. Moreover, cognitive computer systems get better over time as they learn from experience.

How fast the bathtub fills, however, also depends on how much water leaks out of the tub. The outflows represent a reduction in the firm's intangible resource stocks. Resource leakage might occur through employee turnover, especially if key employees leave. Significant resource leakage can erode a firm's competitive advantage. A reduction in resource stocks can occur if a firm does not engage in a specific activity for some time and forgets how to do this activity well.

According to the dynamic capabilities perspective, the managers' task is to decide which investments to make over time (i.e., which faucets to open and how far) in order to best position the firm for competitive advantage in a changing environment. Moreover, managers also need to monitor the existing intangible resource stocks and their attrition rates due to leakage and forgetting. This perspective provides a dynamic understanding of capability development to allow a firm's continuous adaptation to and superior performance in a changing external environment.

value chain

The internal activities a firm engages in when transforming inputs into outputs; each activity adds incremental value.

LO 4-7

Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into outputs generate differentiation and which drive costs.

4.4 The Value Chain and Strategic Activity Systems

THE VALUE CHAIN

The **value chain** describes the internal activities a firm engages in when transforming inputs into outputs.⁴⁴ Each activity the firm performs along the horizontal chain adds incremental value—raw materials and other inputs are transformed into components that are assembled into finished products or services for the end consumer. Each activity the firm performs along the value chain also adds incremental costs. A careful analysis of the

value chain allows managers to obtain a more detailed and fine-grained understanding of how the firm's *economic value creation* ($V - C$) breaks down into a distinct set of activities that help determine perceived value (V) and the costs (C) to create it. The value chain concept can be applied to basically any firm, from those in manufacturing industries to those in high-tech ones or service firms.

A firm's core competencies are deployed through its activities (see Exhibit 4.3). A firm's activities, therefore, are one of the key internal drivers of performance differences across firms. *Activities* are distinct actions that enable firms to add incremental value at each step by transforming inputs into goods and services. Managing a supply chain, running the company's IT system and websites, and providing customer support are all examples of distinct activities. Activities are narrower than functional areas such as marketing, because each functional area is made up of a set of distinct activities.

To build its uniquely cool brand image, Beats Electronics engages in a number of distinct activities. Its iconic Beats headphones are designed by Dr. Dre. To create special editions such as lightweight Beats for sports, Dr. Dre taps into his personal network and works with basketball stars such as Kobe Bryant. Once designed, Beats manufactures its high-end headphones (before the Apple acquisition, that was done in conjunction with Monster Cable Products, a California-based company). Other distinct activities concern the marketing and sales of its products. Beats has not only marketing savvy in product placement and branding with a large number of celebrities across different fields, but it also uses the same savvy in other distinct activities such as packaging and product presentation to create a premium unboxing experience and superb displays in retail outlets—especially important now that its products are in Apple stores. In sum, a number of distinct activities along the value chain are performed to create Beats by Dr. Dre, from initial design to a unique sales experience and after-sales service.

As shown in the generic value chain in Exhibit 4.7, the transformation process from inputs to outputs is composed of a set of distinct activities. When a firm's distinct activities generate value greater than the costs to create them, the firm obtains a profit margin (see Exhibit 4.7), assuming the market price the firm is able to command exceeds the costs of value creation. A generic value chain needs to be modified to capture the

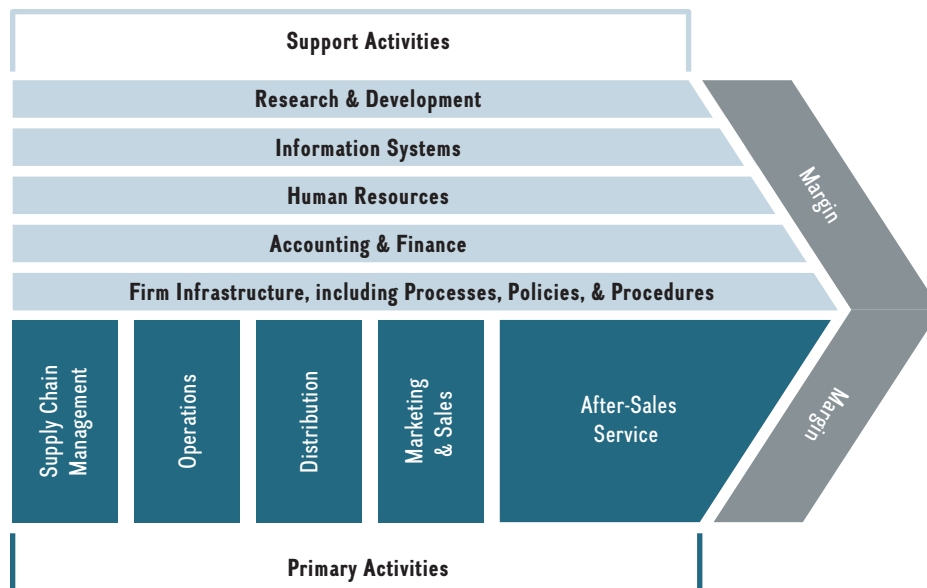


EXHIBIT 4.7 /

A Generic Value Chain: Primary and Support Activities

activities of a specific business. Retail chain American Eagle Outfitters, for example, needs to identify suitable store locations, either build or rent stores, purchase goods and supplies, manage distribution and store inventories, operate stores both in the brick-and-mortar world and online, hire and motivate a sales force, create payment and IT systems or partner with vendors, engage in promotions, and ensure after-sales services including returns. A maker of semiconductor chips such as Intel, on the other hand, needs to engage in R&D, design and engineer semiconductor chips and their production processes, purchase silicon and other ingredients, set up and staff chip fabrication plants, control quality and throughput, engage in marketing and sales, and provide after-sales customer support.

As shown in Exhibit 4.7, the value chain is divided into primary and support activities. The **primary activities** add value directly as the firm transforms inputs into outputs—from raw materials through production phases to sales and marketing and finally customer service, specifically

primary activities Firm activities that add value directly by transforming inputs into outputs as the firm moves a product or service horizontally along the internal value chain.

- Supply chain management.
- Operations.
- Distribution.
- Marketing and sales.
- After-sales service.

Other activities, called **support activities**, add value indirectly. These activities include

support activities Firm activities that add value indirectly, but are necessary to sustain primary activities.

- Research and development (R&D).
- Information systems.
- Human resources.
- Accounting and finance.
- Firm infrastructure including processes, policies, and procedures.

To help a firm achieve a competitive advantage, each distinct activity performed needs to either add incremental value to the product or service offering or lower its relative cost. Discrete and specific firm activities are the basic units with which to understand competitive advantage because they are the drivers of the firm's relative costs and level of differentiation the firm can provide to its customers. Although the resource-based view of the firm helps identify the integrated set of resources and capabilities that are the building blocks of core competencies, the value chain perspective enables managers to see how competitive advantage flows from the firm's distinct set of activities. This is because a firm's core competency is generally found in a network linking different but distinct activities, each contributing to the firm's strategic position as either low-cost leader or differentiator.

LO 4-8

Identify competitive advantage as residing in a network of distinct activities.

STRATEGIC ACTIVITY SYSTEMS

A **strategic activity system** conceives of a firm as a network of interconnected activities.⁴⁵ Strategic activity systems are socially complex and causally ambiguous, thus enhancing the possibility that a competitive advantage can be sustained over time. While one can easily observe several elements of a strategic activity system, the capabilities necessary to orchestrate and manage the network of distinct activities cannot be so easily observed and therefore are difficult to imitate.

Let's assume Firm A's activity system, which lays the foundation of its competitive advantage, consists of 25 interconnected activities. Attracted by Firm A's competitive advantage, competitor Firm B closely monitors this activity system and begins to copy it through direct imitation. Moreover, Firm B is very good at copying; it achieves a 90 percent accuracy rate. Will Firm B, as the imitator, be able to copy Firm A's activity

strategic activity system The conceptualization of a firm as a network of interconnected activities.

system and negate its competitive advantage? Far from it. Firm A's activity system is based on 25 interconnected activities. Because each of Firm A's 25 activities is copied with a 90 percent accuracy, Firm B's overall copying accuracy of the entire system is $0.9 \times 0.9 \times 0.9 \dots$, repeated 25 times. The probabilities quickly compound to render copying an entire activity system nearly impossible. In this case, Firm B's "success" in copying Firm A's activity system is $0.9^{25} = 0.07$, meaning that Firm B's resulting activity system will imitate Firm A's with only a 7 percent accuracy rate. Thus, the concept of the strategic activity system demonstrates the difficulty of using imitation as a path to competitive advantage.

Strategic activity systems need to evolve over time if a firm is to sustain a competitive advantage. Procter & Gamble's difficulties discussed in Strategy Highlight 4.2 show what happens if a firm's strategic activity system does not evolve. This generally leads to a competitive disadvantage, because the external environment changes and also because a firm's competitors get better in developing their own activity systems and capabilities. Managers need to adapt their firm's strategic activity system by upgrading value-creating activities that respond to changing environments. To gain and sustain competitive advantage, strategic leaders may add new activities, remove activities that are no longer relevant, and upgrade activities that have become stale or somewhat obsolete. Each of these changes would require changes to the resources and capabilities involved.

Let's consider The Vanguard Group, one of the world's largest investment companies.⁴⁶ It serves individual investors, financial professionals, and institutional investors such as state retirement funds. Vanguard's mission is to help clients reach their financial goals by being their highest-value provider of investment products and services.⁴⁷ Since its founding in 1929, Vanguard has emphasized low-cost investing and quality service for its clients. Vanguard's average expense ratio (fees as a percentage of total net assets paid by investors) is generally the lowest in the industry.⁴⁸ The Vanguard Group also is a pioneer in passive index-fund investing. Rather than picking individual stocks and trading frequently as done in traditional money management, a mutual fund tracks the performance of an index (such as the Standard & Poor's 500 or the Dow Jones 30), and discourages active trading and encourages long-term investing.

Despite this innovation in investing, Vanguard's strategic activity system needed to evolve over time as the company grew and market conditions as well as competitors changed, in order to gain and sustain a competitive advantage. Let's compare how The Vanguard Group's strategic activity developed over the past 20 years, from 1997 to 2017.

In 1997, The Vanguard Group had less than \$500 million of assets under management. It pursued its mission of being the highest-value provider of investment products and services through its unique set of interconnected activities depicted in Exhibit 4.8. The six larger ovals depict Vanguard's strategic core activities: strict cost control, direct distribution, low expenses with savings passed on to clients, offering of a broad array of mutual funds, efficient investment management approach, and straightforward client communication and education. These six strategic themes were supported by clusters of tightly linked activities (smaller circles), further reinforcing the strategic activity network.

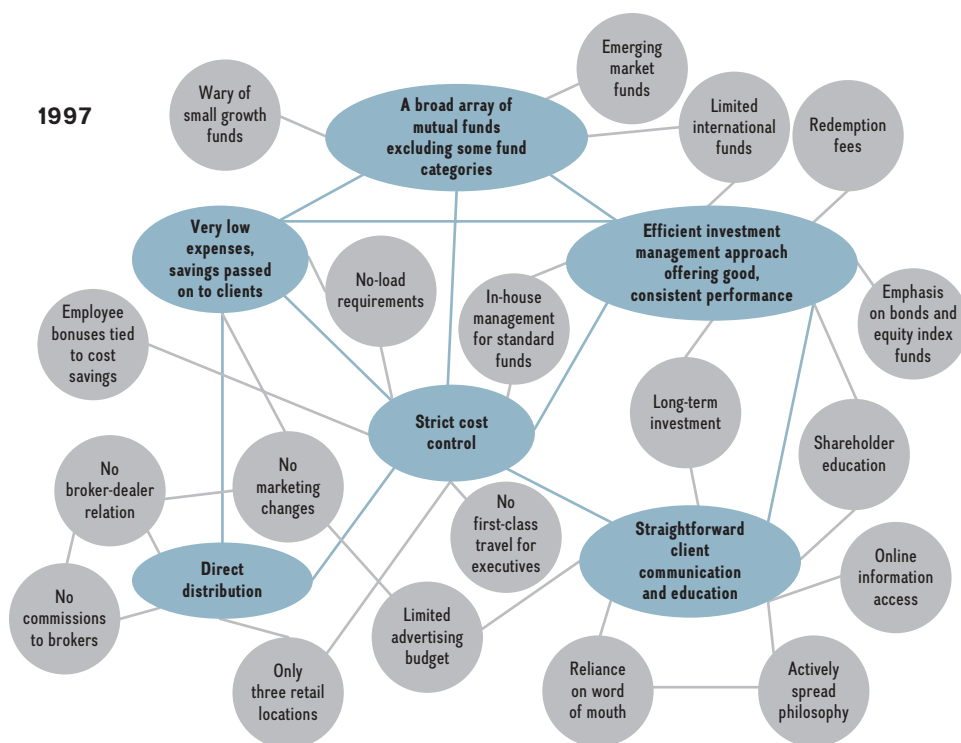
The needs of Vanguard's customers, however, have changed since 1997. Exhibit 4.9 shows Vanguard's strategic activity system in 2017. Twenty years later, The Vanguard Group had grown some eight times in size, from a mere \$500 billion (in 1997) to \$4 trillion (in 2017) of assets under management.⁴⁹

Again, the large ovals in Exhibit 4.9 symbolize Vanguard's strategic core activities that help it realize its strategic position as the low-cost leader in the industry. However, the system evolved over time as Vanguard's management added a new core activity—customer segmentation—to the six core activities already in place in 1997 (still valid in 2017).

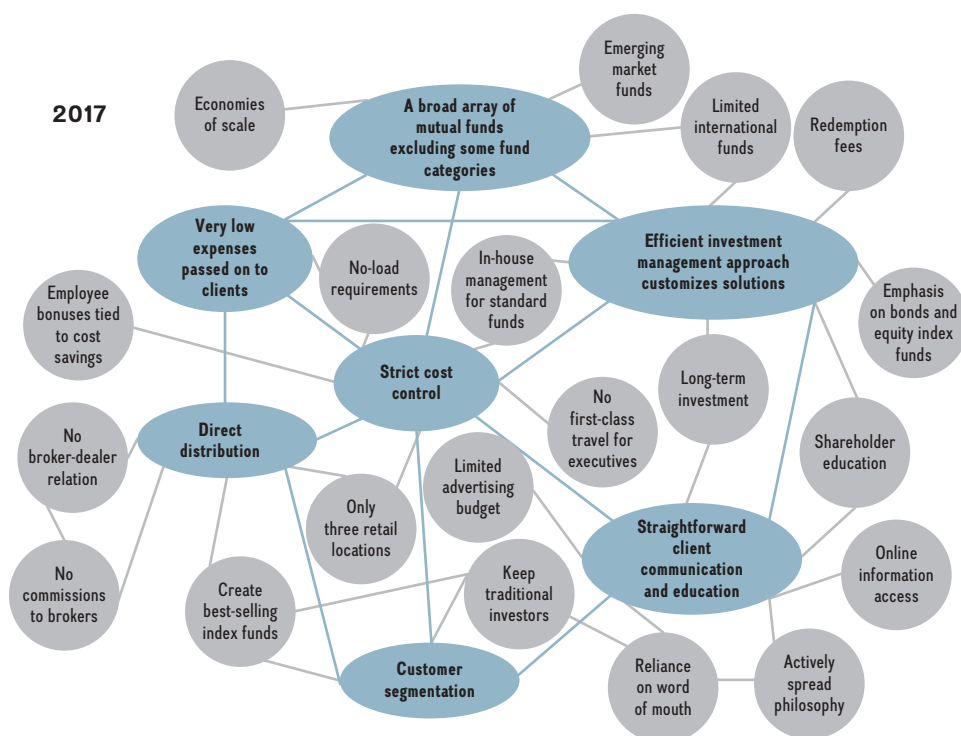
EXHIBIT 4.8 /

The Vanguard Group's
Activity System in
1997

SOURCE: Adapted from N. Siggelkow (2002), "Evolution toward fit," *Administrative Science Quarterly* 47: 146.

**EXHIBIT 4.9** /

The Vanguard Group's
Activity System in
2017



Vanguard's managers put in place the customer-segmentation core activity, along with two new support activities, to address a new customer need that could not be met with its older configuration. Its 1997 activity system did not allow Vanguard to continue to provide quality service targeted at different customer segments at the lowest possible cost. The 2017 activity-system configuration allows Vanguard to customize its service offerings: It now separates its more traditional customers, who invest for the long term, from more active investors, who trade more often but are attracted to Vanguard funds by the firm's high performance and low cost.

The core activity Vanguard added to its strategic activity system was developed with great care, to ensure that it not only fit well with its existing core activities but also further reinforced its activity network. For example, the new activity of "Create best-selling index funds" also relies on direct distribution; it is consistent with and further reinforces Vanguard's low-cost leadership position. As a result of achieving its "best-selling" goal, Vanguard is now the world's second-largest investment-management company, just behind BlackRock, with \$5 trillion of assets under management. This allows Vanguard to benefit from economies of scale (e.g., cost savings accomplished through a larger number of customers served and a greater amount of assets managed), further driving down cost. In turn, by lowering its cost structure, Vanguard can offer more customized services without raising its overall cost. Despite increased customization, Vanguard still has one of the lowest expense ratios in the industry. Even in a changing environment, the firm continues to pursue its strategy of low-cost investing combined with quality service. If firms add activities that don't fit their strategic positioning (e.g., if Vanguard added local retail offices in shopping malls, thereby increasing operating costs), they create "strategic misfits" that are likely to erode a firm's competitive advantage.

The Vanguard Group's core competency of low-cost investing while providing quality service for its clients is accomplished through a unique set of interconnected primary and support activities including strict cost control, direct distribution, low expenses with savings passed on to clients, a broad array of mutual funds, an efficient investment management approach, and straightforward client communication and education.

In summary, a firm's competitive advantage can result from its unique network of activities. The important point, however, is that a static fit with the current environment is not sufficient; rather, a firm's unique network of activities must evolve over time to take advantage of new opportunities and mitigate emerging threats. Moreover, by using activity-based accounting (which first identifies distinct activities in an organization, and then assigns costs to each activity based on estimates of all resources consumed) and by benchmarking the competition, one can identify core competence. In Chapter 5, we take a closer look at how to measure and assess competitive advantage.

4.5 Implications for Strategic Leaders

We've now reached a significant point: We can combine external analysis from Chapter 3 with the internal analysis just introduced. Together the two allow you to begin formulating a strategy that matches your firm's internal resources and capabilities to the demands of the external industry environment. Ideally, strategic leaders want to leverage their firm's internal strengths to exploit external opportunities, while mitigating internal weaknesses and external threats. Both types of analysis in tandem allow managers to formulate a strategy that is tailored to their company, creating a unique fit between the company's internal resources and the external environment. A *strategic fit* increases the likelihood that a firm is able to gain a competitive advantage. If a firm achieves a *dynamic* strategic fit, it is likely to be able to *sustain* its advantage over time.

LO 4-9

Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

USING SWOT ANALYSIS TO GENERATE INSIGHTS FROM EXTERNAL AND INTERNAL ANALYSIS

SWOT analysis
A framework that allows managers to synthesize insights obtained from an internal analysis of the company's strengths and weaknesses (S and W) with those from an analysis of external opportunities and threats (O and T) to derive strategic implications.

We synthesize insights from an internal analysis of the company's *strengths* and *weaknesses* with those from an analysis of external *opportunities* and *threats* using the **SWOT analysis**. Internal strengths (S) and weaknesses (W) concern resources, capabilities, and competencies. Whether they are strengths or weaknesses can be determined by applying the VRIO framework. A resource is a weakness if it is not valuable. In this case, the resource does not allow the firm to exploit an external opportunity or offset an external threat. A resource, however, is a strength and a core competency if it is valuable, rare, costly to imitate, and the firm is organized to capture at least part of the economic value created.

External opportunities (O) and threats (T) are in the firm's general environment and can be captured by PESTEL and Porter's five forces analyses (discussed in the previous chapter). An attractive industry as determined by Porter's five forces, for example, presents an external opportunity for firms not yet active in this industry. On the other hand, stricter regulation for financial institutions, for example, might represent an external threat to banks.

A SWOT analysis allows the strategist to evaluate a firm's current situation and future prospects by simultaneously considering internal and external factors. The SWOT analysis encourages managers to scan the internal and external environments, looking for any relevant factors that might affect the firm's current or future competitive advantage. The focus is on internal and external factors that can affect—in a positive or negative way—the firm's ability to gain and sustain a competitive advantage. To facilitate a SWOT analysis, managers use a set of strategic questions that link the firm's internal environment to its external environment, as shown in Exhibit 4.10, to derive strategic implications. In this SWOT matrix, the horizontal axis is divided into factors that are *external to the firm* (the focus of Chapter 3) and the vertical axis into factors that are *internal to the firm* (the focus of this chapter).

In a first step, managers gather information for a SWOT analysis in order to link internal factors (*Strengths* and *Weaknesses*) to external factors (*Opportunities* and *Threats*). Next, managers use the SWOT matrix shown in Exhibit 4.10 to develop *strategic alternatives* for the firm using a four-step process:

- 1. Focus on the *Strengths–Opportunities* quadrant (top left) to derive “offensive” alternatives by using an internal strength to exploit an external opportunity.
- 2. Focus on the *Weaknesses–Threats* quadrant (bottom right) to derive “defensive” alternatives by eliminating or minimizing an internal weakness to mitigate an external threat.
- 3. Focus on the *Strengths–Threats* quadrant (top right) to use an internal strength to minimize the effect of an external threat.
- 4. Focus on the *Weaknesses–Opportunities* quadrant (bottom left) to shore up an internal weakness to improve its ability to take advantage of an external opportunity.

EXHIBIT 4.10 / Strategic Questions within the SWOT Matrix

		External to Firm	
Internal to Firm	Strategic Questions	Opportunities	Threats
	Strengths	How can the firm use internal strengths to take advantage of external opportunities?	How can the firm use internal strengths to reduce the likelihood and impact of external threats?
	Weaknesses	How can the firm overcome internal weaknesses that prevent it from taking advantage of external opportunities?	How can the firm overcome internal weaknesses that will make external threats a reality?

In a final step, the strategist needs to carefully evaluate the pros and cons of each strategic alternative to select one or more alternatives to implement. Managers need to carefully explain their decision rationale, including why other strategic alternatives were rejected.

Although the SWOT analysis is a widely used management framework, a word of caution is in order. A problem with this framework is that a strength can also be a weakness and an opportunity can also simultaneously be a threat. Earlier in this chapter, we discussed the location of Google's headquarters in Silicon Valley and near several universities as a key resource for the firm. Most people would consider this a strength for the firm. However, California has a high cost of living and is routinely ranked among the worst of the U.S. states in terms of "ease of doing business." In addition, this area of California is along major earthquake fault lines and is more prone to natural disasters than many other parts of the country. So is the location a strength or a weakness? The answer is "it depends." In a similar fashion, is global warming an opportunity or threat for car manufacturers? If governments enact higher gasoline taxes and make driving more expensive, it can be a threat. If, however, carmakers respond to government regulations by increased innovation through developing more fuel-efficient cars as well as low- or zero-emission engines such as hybrid or electric vehicles, it may create more demand for new cars and lead to higher sales.

To make the SWOT analysis an effective management tool, the strategist must first conduct a thorough external and internal analysis, as laid out in Chapters 3 and 4. This sequential process enables the strategist to ground the analysis in rigorous theoretical frameworks before using SWOT to synthesize the results from the external and internal analyses in order to derive a set of strategic options.

You have now acquired the toolkit with which to conduct a complete strategic analysis of a firm's internal and external environments. In the next chapter, we consider various ways to assess and measure competitive advantage. That chapter will complete Part 1, on strategy analysis, in the AFI framework (see Exhibit 1.3).

CHAPTERCASE 4 / Consider This . . .

ALTHOUGH MANY observers are convinced that Apple purchased Beats Electronics for the coolness of its brand and to gain a stronger position in the music industry, others are suggesting that what Apple is really buying are the talents that Beats co-founder Jimmy Iovine and Dr. Dre bring to the table. Since the death of Steve Jobs, Apple's visionary leader, the company has been lacking the kind of inspired personality it needs to remain a cultural icon. The critics argue that what Apple really needs is someone with a creative vision combined with a wide-reaching industry network and the ability to close a deal, especially in music where the personalities of celebrities are known to be idiosyncratic. In music jargon, Apple is in need of a "front man." With the acquisition of Beats, it got two of the greatest creative talents in the music industry, with a long successful track record and deep and far-reaching networks.

Iovine is of the opinion that Beats had always belonged with Apple. Iovine and Dr. Dre set out to model Beats Electronics after Apple's unique ability to marry culture and technology. Intriguingly, both Iovine and Dr. Dre took on senior positions at Apple. They continue to link Beats with today's top talent, even as some celebrities, such as Ariana Grande and Rihanna, take a leaf from the Beats playbook. Some singers now burnish personal brands with limited release headphones from other vendors; Grande's wireless Cat Ear Headphones (Brookstone, \$150) and Rihanna's bedazzled tiara (Friends/Dolce & Gabbana, \$9,000) are just two examples.

That Beats' founders keep ongoing roles indicates how much Apple's culture has changed under CEO Tim Cook.



Dr. Dre and Jimmy Iovine of Beats.

©Kevin Mazur/WireImage/Getty Images

Indeed, Iovine and Dr. Dre were not the first superstars from flashy industries he brought to Apple. In 2013, Apple hired former Burberry CEO Angela Ahrendts to head its retail operations. Bringing in superstars from the flashy industries of music or fashion to Apple, let alone into senior executive roles, would have been unthinkable under Jobs. Under his top-down leadership, only Apple products introduced to the public by himself in well-rehearsed theatrical launches were allowed to shine.

Questions

1. Which music streaming service do you use, if any? Why are you using this particular service and not others? Are you a paid subscriber? Why or why not?
2. The ChapterCase argues that Beats Electronics' core competency lies in its marketing savvy and in Dr. Dre's coolness factor. Do you agree with this assessment? Why or why not?
3. If you believe that Apple bought Beats Electronics to bring Jimmy Iovine and Dr. Dre into Apple, what are the potential downsides of this multibillion-dollar "acqui-hire" (an acquisition to hire key personnel)?
4. If Beats Electronics' core competencies are indeed intangibles, such as coolness and marketing savvy, do you think these competencies will remain as valuable under Apple's ownership? Why or why not?
5. The ChapterCase provides at least three theories why Apple purchased Beats Electronics. Briefly sketch each of them. Which of those do you believe is most accurate, and why?

TAKE-AWAY CONCEPTS

This chapter demonstrated various approaches to analyzing the firm's *internal environment*, as summarized by the following learning objectives and related take-away concepts.

LO 4-1 / Differentiate among a firm's core competencies, resources, capabilities, and activities.

- *Core competencies* are unique, deeply embedded, firm-specific strengths that allow companies to differentiate their products and services and thus create more value for customers than their rivals, or offer products and services of acceptable value at lower cost.
- *Resources* are any assets that a company can draw on when crafting and executing strategy.
- *Capabilities* are the organizational and managerial skills necessary to orchestrate a diverse set of resources to deploy them strategically.
- *Activities* are distinct and fine-grained business processes that enable firms to add incremental value by transforming inputs into goods and services.

LO 4-2 / Compare and contrast tangible and intangible resources.

- *Tangible resources* have physical attributes and are visible.

- *Intangible resources* have no physical attributes and are invisible.
- Competitive advantage is more likely to be based on intangible resources.

LO 4-3 / Evaluate the two critical assumptions behind the resource-based view.

- The first critical assumption—*resource heterogeneity*—is that bundles of resources, capabilities, and competencies differ across firms. The resource bundles of firms competing in the same industry (or even the same strategic group) are unique to some extent and thus differ from one another.
- The second critical assumption—*resource immobility*—is that resources tend to be "sticky" and don't move easily from firm to firm. Because of that stickiness, the resource differences that exist between firms are difficult to replicate and, therefore, can last for a long time.

LO 4-4 / Apply the VRIO framework to assess the competitive implications of a firm's resources.

- For a firm's resource to be the basis of a competitive advantage, it must have VRIO attributes:

valuable (V), rare (R), and costly to imitate (I). The firm must also be able to organize (O) in order to capture the value of the resource.

- A resource is valuable (V) if it allows the firm to take advantage of an external opportunity and/or neutralize an external threat. A valuable resource enables a firm to increase its economic value creation ($V - C$).
- A resource is rare (R) if the number of firms that possess it is less than the number of firms it would require to reach a state of perfect competition.
- A resource is costly to imitate (I) if firms that do not possess the resource are unable to develop or buy the resource at a comparable cost.
- The firm is organized (O) to capture the value of the resource if it has an effective organizational structure, processes, and systems in place to fully exploit the competitive potential.

LO 4-5 / Evaluate different conditions that allow a firm to sustain a competitive advantage.

- Several conditions make it costly for competitors to imitate the resources, capabilities, or competencies that underlie a firm's competitive advantage: (1) *better expectations of future resource value*, (2) *path dependence*, (3) *causal ambiguity*, (4) *social complexity*, and (5) *intellectual property (IP) protection*.
- These *barriers to imitation* are isolating mechanisms because they prevent rivals from competing away the advantage a firm may enjoy.

LO 4-6 / Outline how dynamic capabilities can enable a firm to sustain a competitive advantage.

- To sustain a competitive advantage, any fit between a firm's internal strengths and the external environment must be dynamic.
- *Dynamic capabilities* allow a firm to create, deploy, modify, reconfigure, or upgrade its resource base to gain and sustain competitive advantage in a constantly changing environment.

LO 4-7 / Apply a value chain analysis to understand which of the firm's activities in the process of transforming inputs into

outputs generate differentiation and which drive costs.

- The value chain describes the internal activities a firm engages in when transforming inputs into outputs.
- Each activity the firm performs along the horizontal chain adds incremental value and incremental costs.
- A careful analysis of the value chain allows managers to obtain a more detailed and fine-grained understanding of how the firm's economic value creation breaks down into a distinct set of activities that helps determine perceived value and the costs to create it.
- When a firm's set of distinct activities is able to generate value greater than the costs to create it, the firm obtains a profit margin (assuming the market price the firm is able to command exceeds the costs of value creation).

LO 4-8 / Identify competitive advantage as residing in a network of distinct activities.

- A strategic activity system conceives of a firm as a network of interconnected firm activities.
- A network of primary and supporting firm activities can create a strategic fit that can lead to a competitive advantage.
- To sustain a competitive advantage, firms need to hone, fine-tune, and upgrade their strategic activity systems over time, in response to changes in the external environment and to moves of competitors.

LO 4-9 / Conduct a SWOT analysis to generate insights from external and internal analysis and derive strategic implications.

- Formulating a strategy that increases the chances of gaining and sustaining a competitive advantage is based on synthesizing insights obtained from an internal analysis of the company's strengths (S) and weaknesses (W) with those from an analysis of external opportunities (O) and threats (T).
- The strategic implications of a SWOT analysis should help the firm to leverage its internal strengths to exploit external opportunities, while mitigating internal weaknesses and external threats.

KEY TERMS

Activities (<i>p. 112</i>)	Intellectual property (IP) protection (<i>p. 123</i>)	Resource immobility (<i>p. 114</i>)
Capabilities (<i>p. 110</i>)	Isolating mechanisms (<i>p. 120</i>)	Resource stocks (<i>p. 127</i>)
Causal ambiguity (<i>p. 122</i>)	Organized to capture value (<i>p. 118</i>)	Resources (<i>p. 110</i>)
Core competencies (<i>p. 110</i>)	Path dependence (<i>p. 121</i>)	Social complexity (<i>p. 123</i>)
Core rigidity (<i>p. 124</i>)	Primary activities (<i>p. 130</i>)	Strategic activity system (<i>p. 130</i>)
Costly-to-imitate resource (<i>p. 116</i>)	Rare resource (<i>p. 116</i>)	Support activities (<i>p. 130</i>)
Dynamic capabilities (<i>p. 126</i>)	Resource-based view (<i>p. 113</i>)	SWOT analysis (<i>p. 134</i>)
Dynamic capabilities perspective (<i>p. 127</i>)	Resource flows (<i>p. 127</i>)	Tangible resources (<i>p. 113</i>)
Intangible resources (<i>p. 113</i>)	Resource heterogeneity (<i>p. 114</i>)	Valuable resource (<i>p. 116</i>)
		Value chain (<i>p. 128</i>)
		VRIO framework (<i>p. 115</i>)

DISCUSSION QUESTIONS

- Why is it important to study the internal resources, capabilities, and activities of firms? What insights can be gained?
- Conduct a value chain analysis for McDonald's. What are its primary activities? What are its support activities? Identify the activities that add the most value for the customer. Why? Which activities help McDonald's to contain cost? Why?
 - In the past few years, McDonald's has made a lot of changes to its menu, adding more healthy choices and more higher-priced items, such as those offered in McCafé (e.g., premium roast coffee, antibiotic-free chicken, and fruit smoothies), and has also enhanced its in-restaurant services (e.g., free, unlimited Wi-Fi; upgraded interiors). Did McDonald's new priorities—in terms of a broader, healthier menu and an improved in-restaurant experience—require changes to its traditional value chain activities? If so, how? Try to be as specific as possible in comparing the McDonald's from the recent past (focusing on low-cost burgers) to the McDonald's of today.
- The resource-based view of the firm identifies four criteria that managers can use to evaluate whether particular resources and capabilities are core competencies and can, therefore, provide a basis for sustainable competitive advantage. Are these measures independent or interdependent? Explain. If (some of) the measures are interdependent, what implications does that fact have for managers wanting to create and sustain a competitive advantage?

ETHICAL/SOCIAL ISSUES

- As discussed in this chapter, resources that are valuable, rare, and costly to imitate can help create a competitive advantage. In many cases, firms try to “reverse-engineer” a particular feature from a competitor's product for their own uses. It is common, for example, for smartphone manufacturers to buy the newest phones of their competitors and take them

apart to see what new components and features the models have implemented. However, this sort of corporate behavior does not stop with hardware products. With hundreds of millions of users and rapid growth, China is considered to be one of the most lucrative online markets worldwide. Baidu (baidu.com), a Chinese web services company, has allegedly adapted many of the search tools that Google uses. Baidu, however, modifies its searches inside China (its major market) to accommodate government guidelines. In protest over these same guidelines, in 2010 Google left the Chinese market and is running its Chinese search operations from Hong Kong. Google no longer censors its online searches as requested by the Chinese government. Baidu has an estimated 78 percent market share in online search in China, and Google less than 15 percent.⁵⁰

It is legal to take apart publicly available products and services and try to replicate them and

even develop work-arounds for relevant patents. But is it ethical? If a key capability protected by patents or trademarks in your firm is being reverse-engineered by the competition, what are your options for a response? Also, how do you evaluate Google's decision to move its servers to Hong Kong?

2. The chapter mentions that one type of resource flow is the loss of key personnel who move to another firm. Assume that the human resources department of your firm has started running ads and billboards for open positions near the office of your top competitor. Your firm is also running Google ads on a keyword search for this same competitor. Is there anything unethical about this activity? Would your view change if this key competitor had just announced a major layoff?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Brand valuations were mentioned in the chapter as a potential key intangible resource for firms. Some product brands are so well established the entire category of products (including those made by competitors) may be called by the brand name rather than the product type. In your small group, develop two or three examples of this happening in the marketplace. In any of the cases noted, does such brand valuation give the leading brand a competitive advantage? Or does it produce confusion in the market for all products or services in that category? Provide advice to the leading brand as to how the firm can strengthen the brand name.

//// Small Group Exercise 2

Strategy Highlight 4.1 explains the rise and fall of Groupon. The company's strategic vision was *to be the global leader in local commerce*, based on a core competency that could be described as

"local market-making." Numerous competitors took advantage of low barriers to entry and the easy imitation of Groupon's combined competency of some technology skills with sales skills, so that Groupon found its competitive advantage was only temporary. Groupon continues to compete but needs your advice on how to build dynamic capabilities that might help it pursue the vision of becoming a global leader in local commerce. How might Groupon reinvest or upgrade its technology and sales skills so it builds a global customer base? For example, are there new products or services that would meet the needs of global clients in each of the local markets? Should they try to compete with the newer "hyper-local" offerings or move in a different direction? Brainstorm ways that Groupon might add value for its customers. How might Groupon build relationships with clients that are more socially complex, making Groupon's competencies more difficult to imitate?

mySTRATEGY

Looking Inside Yourself: What Is My Competitive Advantage?

We encourage you to apply what you have learned about competitive advantage to your career. Spend a few minutes looking at yourself to discover *your own* competitive advantage. If you have previous work experience, these questions should be from a work environment perspective. If you do not have any work experience yet, use these questions to evaluate a new workplace or as strategies for presenting yourself to a potential employer.

1. Write down your own strengths and weaknesses. What sort of organization will permit you to really leverage your strengths and keep you highly engaged in your work (person–organization fit)? Do some of your weaknesses need to be mitigated through additional training or mentoring from a more seasoned professional?
2. Personal capabilities also need to be evaluated over time. Are your strengths and weaknesses different today from what they were five years ago? What are you doing to make sure your capabilities are dynamic?
3. Are some of your strengths valuable, rare, and costly to imitate? How can you organize your work to help capture the value of your key strengths (or mitigate your weaknesses)? Are your strengths specific to one or a few employers, or are they more generally valuable in the marketplace? In general, should you be making investments in your human capital in terms of company-specific or market-general skills?
4. As an employee, how could you persuade your boss that you could be a vital source of sustainable competitive advantage? What evidence could you provide to make such an argument?

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CHAPTER

5

Competitive Advantage, Firm Performance, and Business Models

Chapter Outline

- 5.1 Competitive Advantage and Firm Performance**
 - Accounting Profitability*
 - Shareholder Value Creation*
 - Economic Value Creation*
 - The Balanced Scorecard*
 - The Triple Bottom Line*
- 5.2 Business Models: Putting Strategy into Action**
 - The Why, What, Who, and How of Business Models Framework*
 - Popular Business Models*
 - Dynamic Nature of Business Models*
- 5.3 Implications for Strategic Leaders**

Learning Objectives

- LO 5-1** Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.
- LO 5-2** Apply shareholder value creation to assess and evaluate competitive advantage.
- LO 5-3** Explain economic value creation and different sources of competitive advantage.
- LO 5-4** Apply a balanced scorecard to assess and evaluate competitive advantage.
- LO 5-5** Apply a triple bottom line to assess and evaluate competitive advantage.
- LO 5-6** Use the why, what, who, and how of business models framework to put strategy into action.

The Quest for Competitive Advantage: Apple vs. Microsoft

APPLE AND MICROSOFT have been fierce rivals since their arrival in the mid-1970s. Although Apple has been dominating more recently, in the early decades of the PC revolution, Microsoft was the undisputed leader. With its Windows operating system, Microsoft set the standard in the world of personal computers. Some 90 percent of all PCs run Windows. Once users are locked into Windows, which generally comes preloaded on the computer they purchased, they then want to buy applications that run seamlessly with the operating system. The obvious choice for users is Microsoft's Office Suite (containing Word, Excel, PowerPoint, Outlook, and other software programs). Microsoft's business model was to create a large installed base of users for its PC operating system and then make money selling application software such as its ubiquitous Office Suite.

Microsoft then went on to replicate with its corporate customers this hugely successful business model of setting the standard in operating systems combined with bundling discounted application suites. Once servers became ubiquitous in corporations, Microsoft offered IT departments e-mail systems, databases, and other business applications that were tightly integrated with Windows. As a consequence, some 80 percent of Microsoft's revenues were either tied directly or indirectly to its Windows franchise. Microsoft's strategy of focusing on setting the industry standard allowed it to create a strong strategic position and to extract high profits for many years. Microsoft's bundling strategy with Office, combining different application services that run seamlessly in one discounted product offering, allowed Microsoft to overtake IBM, once the most valuable tech company. By 2000, Microsoft was the most valuable company globally with some \$510 billion in market capitalization.

In contrast, at roughly the same time, Apple was struggling to survive with less than 5 percent market share in the PC market. Near bankruptcy in 1997, Apple's revitalization took off in the fall of 2001 when it introduced the iPod, a portable digital music player. Eighteen months later, the Cupertino, California, company soared even higher when it opened the online store iTunes, quickly followed by its first retail stores. Apple's stores earn the highest sales per square foot of any retail outlets, including luxury stores.

Apple didn't stop there. In 2007, the company revolutionized the smartphone market with the introduction of the iPhone. Just three years later, Apple introduced the iPad, reshaping the publishing and media industries. Further, for each of its iPod, iPhone, and iPad lines of business, Apple followed up with incremental product innovations extending each product category. By the fall of 2012, Apple had become the most valuable company in the world with some \$620 billion market capitalization.

In 2015, the high-tech company introduced

Apple Watch, a wearable computer that is fully integrated with the iOS Apple operating system, running basically all the apps available for the iPhone. Not to be stopped, Apple introduced its 10th anniversary iPhone in 2017 to great fanfare, with a curved screen and priced at about \$1,000. In the same year, Apple's market capitalization had further risen to more than \$750 billion.

The comparison of Microsoft and Apple over time shows that competitive advantage is transitory. Given the rough-and-tumble competition combined with relentless technological progress and innovation, it is hard to gain a competitive advantage in the first place, and it is even harder to sustain it.¹

You will learn more about Apple and Microsoft by reading this chapter; related questions appear in "ChapterCase 5 / Consider This . . ."

NOTE: A financial ratio review related to this ChapterCase is available in Connect.



One of the few photos depicting Steve Jobs (Apple co-founder and longtime CEO) and Bill Gates (Microsoft co-founder and longtime CEO) together shows the erstwhile archrivals apparently enjoying each other's company. Taken at All Things Digital 5 in 2007. ©Reprinted by permission of WSJ, Copyright July 8, 2007, Dow Jones & Company, Inc.



GAINING AND SUSTAINING competitive advantage is the defining goal of strategic management. Competitive advantage leads to superior firm performance. To explain differences in firm performance and to derive strategic implications—including new strategic initiatives—we must understand how to measure and assess competitive advantage. We devote this chapter to studying how to measure and assess firm performance. In particular, we introduce three frameworks to capture the multifaceted nature of competitive advantage. The three traditional frameworks to measure and assess firm performance are

- Accounting profitability.
- Shareholder value creation.
- Economic value creation.

We then will introduce two integrative frameworks, combining quantitative data with qualitative assessments:

- The balanced scorecard.
- The triple bottom line.

Next, we take a closer look at *business models* to understand more deeply how firms put their strategy into action to make money. We conclude the chapter with practical *Implications for Strategic Leaders*.

5.1 Competitive Advantage and Firm Performance

It is easy to compare two firms and identify the better performer as having competitive advantage. But simple comparisons have their limitations. How can we understand how and why a firm has competitive advantage? How can we measure it? How can we understand that advantage within the bigger picture of an entire industry and the ever-changing external environment? And what strategic implications for managerial actions do we derive from our assessments? These apparently simple questions do not have simple answers. Strategic management researchers have debated them intensely for the past few decades.²

To address these key questions, we will develop a *multidimensional perspective* for assessing competitive advantage. Let's begin by focusing on the three standard performance dimensions:³

1. What is the firm's *accounting profitability*?
2. How much *shareholder value* does the firm create?
3. How much *economic value* does the firm generate?

These three performance dimensions tend to be correlated, particularly over time. Accounting profitability and economic value creation tend to be reflected in the firm's stock price, which in turn determines in part the stock's market valuation.

LO 5-1

Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.

ACCOUNTING PROFITABILITY

As we discussed in Chapter 1, *strategy* is a set of goal-directed actions a firm takes to gain and sustain competitive advantage. Using accounting data to assess competitive advantage and firm performance is standard managerial practice. When assessing competitive advantage by measuring accounting profitability, we use financial data and ratios derived from publicly available accounting data such as income statements and balance sheets.⁴ Since *competitive advantage* is defined as superior performance *relative* to other competitors in

the same industry or the industry average, a firm's managers must be able to accomplish two critical tasks:

1. Accurately assess the performance of their firm.
2. Compare and benchmark their firm's performance to other competitors in the same industry or against the industry average.

Standardized financial metrics, derived from such publicly available accounting data as income statements and balance sheets, fulfill both these conditions. Public companies are required by law to release these data, in compliance with generally accepted accounting principles (GAAP) set by the Financial Accounting Standards Board (FASB), and as audited by certified public accountants. Publicly traded firms are required to file a Form 10-K (or 10-K report) annually with the U.S. Securities and Exchange Commission (SEC), a federal regulatory agency. The 10-K reports are the primary source of companies' accounting data available to the public. The fairly stringent requirements applied to accounting data that are audited and released publicly enhance the data's usefulness for comparative analysis.

Accounting data enable us to conduct direct performance comparisons between different companies. Some of the profitability ratios most commonly used in strategic management are *return on invested capital (ROIC)*, *return on equity (ROE)*, *return on assets (ROA)*, and *return on revenue (ROR)*. In the "How to Conduct a Case Analysis" module (at the end of Part 4, following the MiniCases), you will find a complete presentation of accounting measures and financial ratios, how they are calculated, and a brief description of their strategic characteristics.

One of the most commonly used metrics in assessing firm financial performance is *return on invested capital (ROIC)*, where $ROIC = (\text{Net profits} / \text{Invested capital})$.⁵ ROIC is a popular metric because it is a good proxy for *firm profitability*. In particular, the ratio measures how effectively a company uses its *total invested capital*, which consists of two components: (1) *shareholders' equity* through the selling of shares to the public, and (2) *interest-bearing debt* through borrowing from financial institutions and bondholders.

As a rule of thumb, if a firm's ROIC is greater than its cost of capital, it generates value; if it is less than the cost of capital, the firm destroys value. The *cost of capital* represents a firm's cost of financing operations from both equity through issuing stock and debt through issuing bonds. To be more precise and to be able to derive strategic implications, however, managers must compare their ROIC to other competitors and the industry average.

APPLE VS. MICROSOFT. To demonstrate the usefulness of accounting data in assessing competitive advantage and to derive strategic implications, let's revisit the comparison between Apple and Microsoft that we began in ChapterCase 5, and investigate the sources of performance differences in more detail.⁶ Exhibit 5.1 shows the ROIC for Apple and Microsoft as of fiscal year 2016.⁷ It further breaks down ROIC into its constituent components. This provides important clues for managers on which areas to focus when attempting to improve firm performance relative to their competitors.

Apple's ROIC is 18.3 percent, which is 4.6 percentage points higher than Microsoft's (13.7 percent). This means that for every \$1.00 invested in Apple, the company returned almost \$1.18, while for every \$1.00 invested in the company, Microsoft returned \$1.13. Since Apple was 33 percent more efficient than Microsoft at generating a return on invested capital, Apple had a clear competitive advantage over Microsoft. Although this is an important piece of



Tim Cook, Apple CEO.

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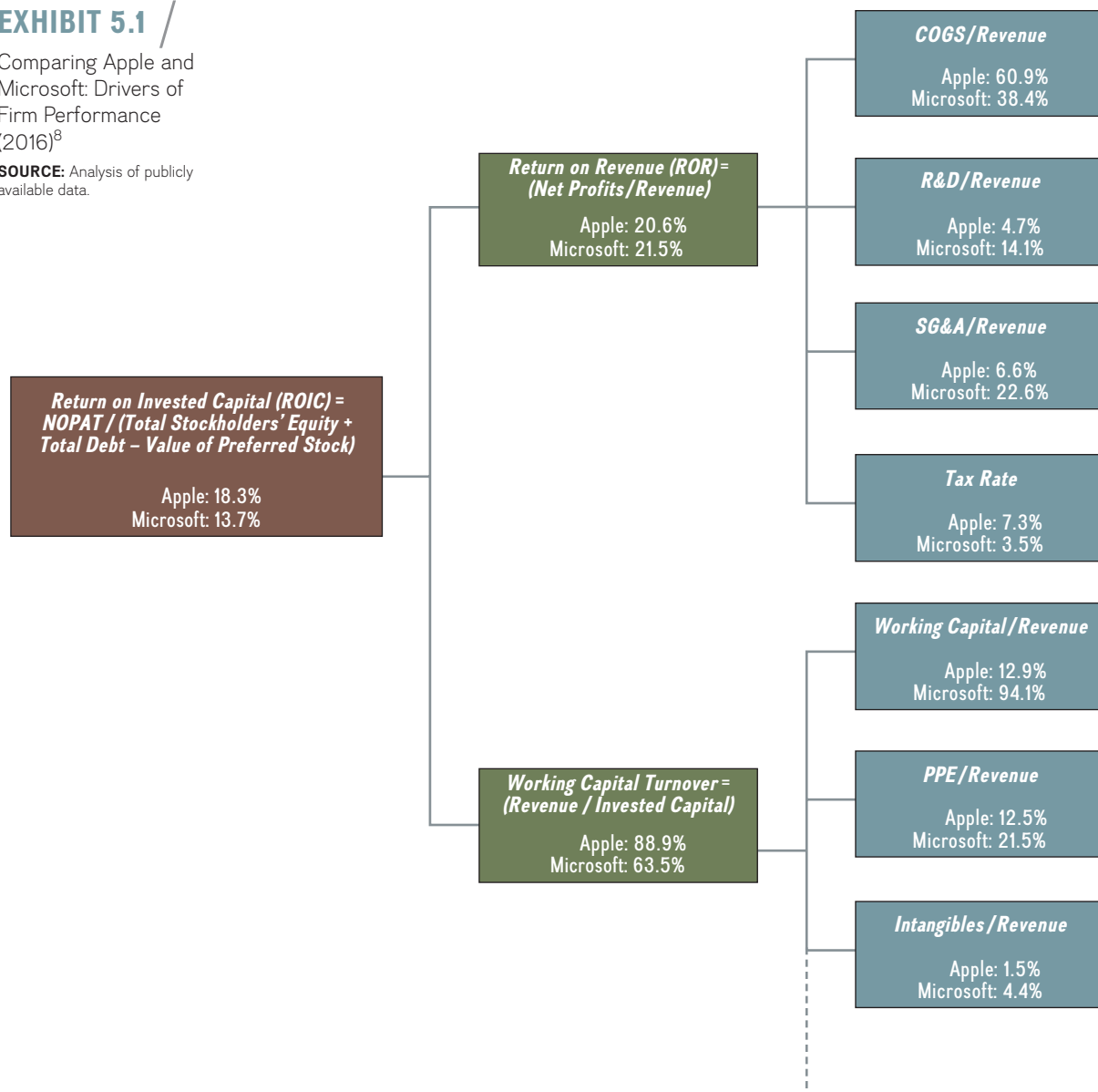
Satya Nadella, Microsoft CEO.

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Getty Images

EXHIBIT 5.1 /

Comparing Apple and Microsoft: Drivers of Firm Performance (2016)⁸

SOURCE: Analysis of publicly available data.



information, managers need to know the underlying factors driving differences in firm profitability. Why is the ROIC for these two companies different?

Much like detectives, managers look for clues to solve that mystery: They break down ROIC into its constituents (as shown in Exhibit 5.1)—*return on revenue* and *working capital turnover*—to discover the underlying drivers of the marked difference in firm profitability.

We start with the first component of ROIC. *Return on revenue (ROR)* indicates how much of the firm's sales is converted into profits. Apple's ROR was 20.6 percent, while Microsoft's ROR was 21.5 percent. For every \$100 in revenues, Apple earns \$20.60 in profit, while Microsoft earns \$21.50 in profit. On this metric, Microsoft had a slight edge over Apple. Keep in mind, however, that Apple's 2016 revenues were \$218 billion, while Microsoft's were \$86 billion. Thus, Apple is more than 2.5 times larger than Microsoft

in terms of annual sales. As we investigate the differences in ROIC further, we will also discover that Microsoft has a higher cost structure than Apple, and that Apple is able to charge a much higher margin for its products and services than Microsoft.

To explore further drivers of this difference, we break down return on revenue into three additional financial ratios:

- Cost of goods sold (COGS) / Revenue.
- Research & development (R&D) expense / Revenue.
- Selling, general, & administrative (SG&A) expense / Revenue.

The first of these three ratios, *COGS / Revenue*, indicates how efficiently a company can produce a good. On this metric, Microsoft turns out to be much more efficient than Apple, with a difference of 22.5 percentage points (see Exhibit 5.1). This is because Microsoft's vast majority of revenues comes from software and online cloud services, with little cost attached to such digitally delivered products and services. In contrast, Apple's revenues were mostly from mobile devices, combining both hardware and software. In particular, the iPhone made up some two-thirds (or over \$145 billion) of Apple's total revenues in 2016.

Even though Apple is more than two times as large as Microsoft in terms of revenues, it spends much less on research and development or on marketing and sales. Both of these help drive down Apple's cost structure. In particular, the next ratio, *R&D / Revenue*, indicates how much of each dollar that the firm earns in sales is invested to conduct research and development. A higher percentage is generally an indicator of a stronger focus on innovation to improve current products and services, and to come up with new ones.

Interestingly, Apple is much less R&D intensive than Microsoft. Apple spent 4.7 percent on R&D for every dollar of revenue, while Microsoft spent almost three times as much (14.1 percent R&D). Even considering the fact that Microsoft's revenues were \$86 billion versus Apple's \$218 billion, Microsoft (\$12 billion) spent more on R&D in absolute dollars than Apple (\$10 billion). For every \$100 earned in revenues Microsoft spent \$14.10 on R&D, while Apple only spent \$4.70. For more than a decade now, Microsoft generally spends the most on R&D in absolute terms among all technology firms.

In contrast, Apple has spent much less on research and development than other firms in the high-tech industry, in both absolute and relative terms. Apple's co-founder and long-time CEO, the late Steve Jobs, defined Apple's R&D philosophy as follows: "Innovation has nothing to do with how many R&D dollars you have. When Apple came up with the Mac, IBM was spending at least 100 times more on R&D. It's not about money. It's about the people you have, how you're led, and how much you get it."⁹

The third ratio in breaking down return on revenue, *SG&A / Revenue*, indicates how much of each dollar that the firm earns in sales is invested in sales, general, and administrative (SG&A) expenses. Generally, this ratio is an indicator of the firm's focus on marketing and sales to promote its products and services. For every \$100 earned in revenues Microsoft spent \$22.60 on sales and marketing, while Apple spent \$6.60.

Again, Microsoft (\$19.4 billion) not only outspent Apple (\$14.4 billion) in absolute terms in marketing and sales expenses, but its SG&A intensity was more than 3.4 times as high as Apple's. Microsoft is spending significantly more to rebuild its brand, especially on Microsoft CEO Satya Nadella's new strategic initiative of "mobile first, cloud first."¹⁰ A focus on cloud computing on mobile devices marks a significant departure from Microsoft's Windows-centric strategy for PCs under his predecessor, Steve Ballmer. Yet, by 2017, the Windows and Office combination still generates about 40 percent of Microsoft's total revenues and 75 percent of its profits. Microsoft is working hard to transition

the Office business from the old business model of standalone software licenses (\$150 for Office Home & Student) to repeat business via cloud-based subscriptions such as Office 365 Home & Student (which is \$70 per year).

We also note, for completeness, that Apple's effective tax rate in 2016 was 7.3 percent (with a net income of \$45 billion), while that of Microsoft was 3.5 percent (with a net income of \$17 billion).

The second component of ROIC is *Working Capital Turnover* (see Exhibit 5.1), which is a measure of how effectively capital is being used to generate revenue. In more general terms, working capital entails the amount of money a company can deploy in the short term, calculated as *current assets* minus *current liabilities*. This is where Apple outperforms Microsoft by a fairly wide margin (88.9 percent vs. 63.5 percent). For every dollar that Apple puts to work, it realizes \$89.90 of sales, while Microsoft realizes \$63.50 of sales for every dollar invested; a difference of \$26.40 in sales for every dollar invested. This implies that Apple is more than 40 percent more efficient than Microsoft in turning invested capital into revenues.

This significant difference provides an important clue for Microsoft's managers to dig deeper to find the underlying drivers in working capital turnover. This enables managers to uncover which levers to pull in order to improve firm financial performance. In a next step, therefore, managers break down working capital turnover into other constituent financial ratios, including *Working Capital / Revenue*; *Plant, Property, and Equipment (PPE) / Revenue*; and *Intangibles / Revenue*. Each of these metrics is a measure of how effective a particular item on the balance sheet is contributing to revenue.

The *working capital to revenue* ratio indicates how much of its working capital the firm has tied up in its operations. Apple (with a *working capital to revenue* ratio of 12.9 percent) operates much more efficiently than Microsoft (*working capital to revenue* ratio of 94.1 percent), because it has much less capital tied up in its operations. One reason is that Apple outsources its manufacturing. The vast majority of Apple's manufacturing of its products is done in China by low-cost producer Foxconn, which employs over 1.3 million people. Moreover, Apple benefits from continued strong demand for its products (especially the iPhone), as well as an effective management of its global supply chain. Rather than outsourcing manufacturing to Foxconn or other original equipment manufacturers (OEMs), Microsoft owns and operates some of its manufacturing facilities. They are also located in countries with a generally higher cost structure (e.g., Brazil and Mexico, among others) than China.

Although Apple's installed base of iPhone users globally is more than 530 million, one significant area of future vulnerability for Apple is the fact that about 60 to 70 percent of its annual revenues is based on sales of a single product—the iPhone, depending on model year. Moreover, China accounts for more than 20 percent of Apple's total revenues, a market that is becoming more and more volatile for the Cupertino-based tech company. These are pressing issues that Apple CEO Tim Cook needs to address in order to sustain Apple's competitive advantage.

The *PPE over revenue* ratio indicates how much of a firm's revenues are dedicated to cover *plant, property, and equipment*, which are critical assets to a firm's operations but cannot be liquidated easily. One reason Microsoft's *PPE to revenue* ratio (21.5 percent) is significant higher than that of Apple (12.5 percent) is the fact that Microsoft invests huge amounts of money to build its cloud business, Azure. To do so, it needs to build hundreds of data centers (large groups of networked computer servers used for the remote storage, processing, or distribution of large amounts of data) across the globe, a costly proposition reflected in high *PPE* expenditures on a much lower revenue base than Apple. On the upside, Azure is already reporting some \$10 billion in sales, second

only to Amazon's AWS with \$12 billion in sales as the world's largest cloud-computing services provider.

One ratio that points toward possible stronger performance in the future is Microsoft's higher *Intangibles / Revenue* ratio when comparing it to Apple's (see Exhibit 5.1). Intangible assets do not have physical attributes (see discussion of intangible resources in Chapter 4), and include a firm's intellectual property (such as patents, copyrights, and trademarks), goodwill, and brand value. One way to think about this is that intangibles are the missing piece to be added to a firm's physical resource base (that is *plant, property, and equipment* and *current assets*) to make up a company's total asset base. With a higher *Intangibles / Revenue* ratio (albeit from a lower revenue base), Microsoft (4.4 percent) seems to be building a stronger intangible intensity (*Intangibles / Revenue*) compared with Apple (1.5 percent), which might position Microsoft stronger for innovation in future business areas such as cloud computing.

A second area of future growth for Microsoft is likely to be artificial intelligence (AI). For example, algorithms combing through vast amounts of data on professionals and their networks might be able to tell sales staff on which leads to spend most of their time. This explains why Microsoft paid \$26 billion in 2016 to acquire LinkedIn, a professional social network with some 100 million monthly active users.

A deeper understanding of the fundamental drivers for differences in firm profitability allows managers to develop strategic approaches. For example, CEO Satya Nadella could rework Microsoft's cost structure, in particular, its fairly high R&D and SG&A spending. Perhaps, R&D dollars could be spent more effectively. Apple generates a much higher return on its R&D spending. Microsoft's sales and marketing expenses also seem to be quite high, but may be needed to rebuild Microsoft's brand image with a new focus on mobile and cloud computing.

LIMITATIONS OF ACCOUNTING DATA. Although accounting data tend to be readily available and we can easily transform them into financial ratios to assess and evaluate competitive performance, they also exhibit some important limitations:

- *All accounting data are historical and thus backward-looking.* Accounting profitability ratios show us only the outcomes from past decisions, and the past is no guarantee of future performance. There is also a significant time delay before accounting data become publicly available. Some strategists liken making decisions using accounting data to driving a car by looking in the rearview mirror.¹¹ While financial strength certainly helps, past performance is no guarantee that a company is prepared for market disruption.
- *Accounting data do not consider off-balance sheet items.* Off-balance sheet items, such as pension obligations (quite large in some U.S. companies) or operating leases in the retail industry, can be significant factors. For example, one retailer may own all its stores, which would properly be included in the firm's assets; a second retailer may lease all its stores, which would *not be* listed as assets. All else being equal, the second retailer's return on assets (ROA) would be higher. Strategists address this shortcoming by adjusting accounting data to obtain an *equivalent* economic capital base, so that they can compare companies with different capital structures.
- *Accounting data focus mainly on tangible assets, which are no longer the most important.*¹² This limitation of accounting data is nicely captured in the adage: *Not everything that can be counted counts. Not everything that counts can be counted.*¹³ Although accounting data capture some intangible assets, such as the value of intellectual property (patents, trademarks, and so on) and customer goodwill, many key intangible assets



Satya Nadella, Microsoft CEO.

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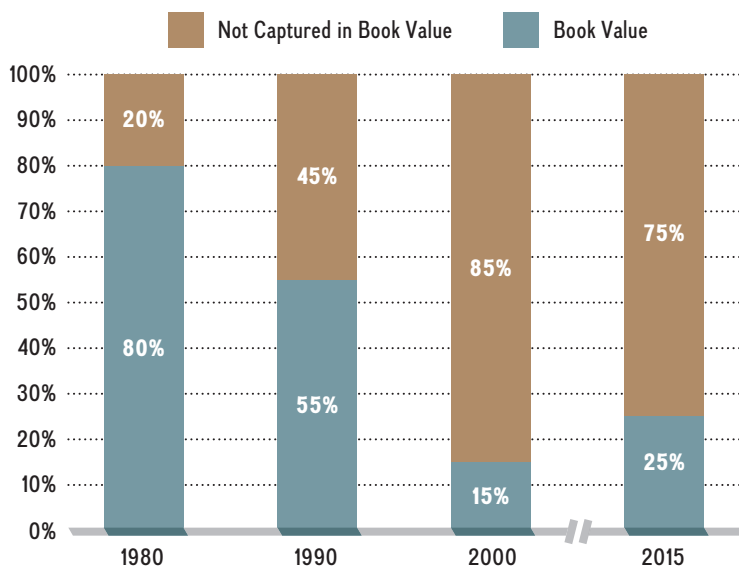
are not captured. Today, the most competitively important assets tend to be intangibles such as innovation, quality, and customer experience, which are not included in a firm's balance sheets. For example, Apple's core competency in designing beautiful and user-friendly mobile devices embedded within a large ecosystem of various services such as ApplePay is not a balance sheet item, but nonetheless a critical foundation in its quest for competitive advantage.

INTANGIBLES AND THE VALUE OF FIRMS. Intangible assets that are not captured in accounting data have become much more important in firms' stock market valuations over the last few decades. Exhibit 5.2 shows the firm's book value (accounting data capturing the firm's actual costs of assets minus depreciation) as part of a firm's total stock market valuation (number of outstanding shares times share price). The firm's book value captures the historical cost of a firm's assets, whereas market valuation is based on future expectations for a firm's growth potential and performance. For the firms in the S&P 500 (the 500 largest publicly traded companies by market capitalization in the U.S. stock market, as determined by Standard & Poor's, a rating agency), the importance of a firm's book value has declined dramatically over time. This decline mirrors a commensurate increase in the importance of intangibles that contribute to growth potential and yet are not captured in a firm's accounting data.

In 1980, about 80 percent of a firm's stock market valuation was based on its book value with 20 percent based on the market's expectations concerning the firm's future performance. This almost reversed by 2000 (at the height of the internet bubble), when firm valuations were based only 15 percent on assets captured by accounting data. The important take-away is that intangibles not captured in firms' accounting data have become much more important to a firm's competitive advantage. By 2015, about 75 percent of a firm's market valuation was determined by its intangibles. This explains why in 2017 Alphabet, Google's parent company (\$580 billion), is valued over 10 times more than GM (\$50 billion), or why Facebook (\$400 billion) is valued almost four times as much as Boeing (\$110 billion).

So what have we learned about accounting profitability? Key financial ratios based on accounting data give us an important tool with which to assess competitive advantage. In particular, they help us measure *relative* profitability, which is useful when comparing firms of different sizes over time. While not perfect, these ratios are an important starting point when analyzing the competitive performance of firms (and thus are a critical tool for case analysis). Again, see the "How to Conduct a Case Analysis" module at the end of Part 4. We next turn to *shareholder value creation* as a second traditional way to measure and assess competitive advantage, attempting to overcome the shortcomings of a backward-looking internal focus on mostly tangible assets inherent in accounting profitability.

EXHIBIT 5.2 / The Declining Importance of Book Value in a Firm's Stock Market Valuation, 1980–2015



SOURCE: Analysis and depiction of data from Compustat, 1980–2015.

SHAREHOLDER VALUE CREATION

Shareholders—individuals or organizations that own one or more shares of stock in a public company—are the legal owners of public companies. From the shareholders' perspective, the measure of competitive advantage that matters most is the return on their **risk capital**,¹⁴ which is the money they provide in return for an equity share, money that they cannot recover if the firm goes bankrupt. In September 2008, the shareholders of Lehman Brothers, a global financial services firm, lost their entire investment of about \$40 billion when the firm declared bankruptcy.

Investors are primarily interested in a company's **total return to shareholders**, which is the return on risk capital, including stock price appreciation plus dividends received over a specific period. Unlike accounting data, total return to shareholders is an *external* and *forward-looking* performance metric. It essentially indicates how the stock market views all available public information about a firm's past, current state, and expected future performance, with most of the weight on future growth expectations. The idea that all available information about a firm's past, current state, and expected future performance is embedded in the market price of the firm's stock is called the *efficient-market hypothesis*.¹⁵ In this perspective, a firm's share price provides an objective performance indicator. When assessing and evaluating competitive advantage, a comparison of rival firms' share price development or market capitalization provides a helpful yardstick when used over the *long term*. **Market capitalization** (or market cap) captures the total dollar market value of a company's total outstanding shares at any given point in time (*Market cap = Number of outstanding shares × Share price*). If a company has 50 million shares outstanding, and each share is traded at \$200, the market capitalization is \$10 billion ($50,000,000 \times \$200 = \$10,000,000,000$, or \$10 billion).¹⁶

All public companies in the United States are required to report total return to shareholders annually in the statements they file with the Securities and Exchange Commission (SEC). In addition, companies must also provide benchmarks, usually one comparison to the industry average and another to a broader market index that is relevant for more diversified firms.¹⁷ Since competitive advantage is defined in relative terms, these benchmarks allow us to assess whether a firm has a competitive advantage. In its annual reports, Microsoft, for example, compares its performance to two stock indices: the NASDAQ computer index and the S&P 500. The computer index includes over 400 high-tech companies traded on the NASDAQ, including Apple, Adobe, Google, Intel, and Oracle. It provides a comparison of Microsoft to the computer industry—broadly defined. The S&P 500 offers a comparison to the wider stock market beyond the computer industry. In its 2016 annual report, Microsoft shows that it *outperformed* both the NASDAQ computer index and the S&P 500 over the last year, while performing roughly at the same levels in previous years.

Effective strategies to grow the business can increase a firm's profitability and thus its stock price.¹⁸ Indeed, investors and Wall Street analysts expect continuous growth. A firm's stock price generally increases only if the firm's rate of growth exceeds investors' expectations. This is because investors discount into the present value of the firm's stock price whatever growth rate they foresee in the future. If a low-growth business like Comcast (in cable TV) is expected to grow 2 percent each year but realizes 4 percent growth, its stock price will appreciate. In contrast, if a fast-growing business like Apple in mobile computing is expected to grow by 10 percent annually but delivers "only" 8 percent growth, its stock price will fall.

Investors also adjust their expectations over time. Since the business in the slow-growth industry surprised them by delivering higher than expected growth, they adjust their expectations upward. The next year, they expect this firm to again deliver 4 percent growth. On the other hand, if the industry average is 10 percent a year in the high-tech business, the firm that delivered 8 percent growth will again be expected to deliver at least the industry average growth rate; otherwise, its stock will be further discounted.

LO 5-2

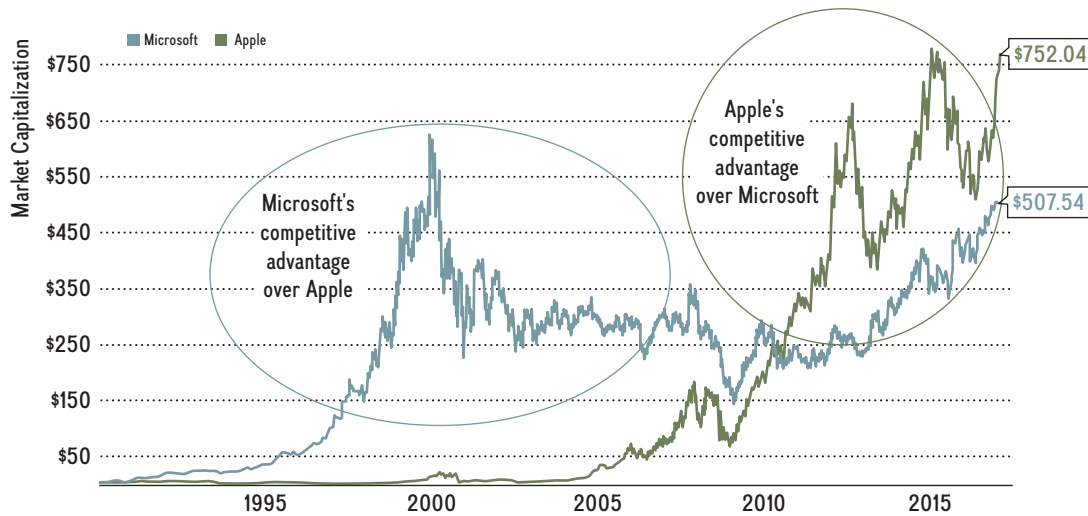
Apply shareholder value creation to assess and evaluate competitive advantage.

shareholders Individuals or organizations that own one or more shares of stock in a public company.

risk capital The money provided by shareholders in exchange for an equity share in a company; it cannot be recovered if the firm goes bankrupt.

total return to shareholders Return on risk capital that includes stock price appreciation plus dividends received over a specific period.

market capitalization A firm performance metric that captures the total dollar market value of a company's total outstanding shares at any given point in time.

EXHIBIT 5.3 / Stock Market Valuations of Apple and Microsoft (in \$ billion), 1990–2017

SOURCE: Depiction of publicly available data.

In ChapterCase 5, we noted that Apple was the most valuable company on the planet. In 2017, Apple's market cap was over \$750 billion. Consistent with the notion that a firm's market capitalization reflects its future growth expectations, the next four largest companies are all tech companies: Alphabet (\$580 billion), Microsoft (\$500 billion), Amazon.com (\$430 billion), and Facebook (\$400 billion).

Considering stock market valuations ($\text{Share price} \times \text{Number of outstanding shares}$) over the long term provides a useful metric to assess competitive advantage. Exhibit 5.3 shows the stock market valuations for Apple and Microsoft from 1990 until 2017. Microsoft was once the most valuable company worldwide (in December 1999 with close to \$600 billion in market cap), but its market valuation dropped in the following decade. The valuation declined because Microsoft struggled with the transition from desktop to mobile and cloud-based computing. CEO Satya Nadella vows to move Microsoft away from its Windows-only business model to compete more effectively in a "mobile first, cloud first world."¹⁹ It appears that Nadella's strategic initiative is bearing fruit as investors appear to be pleased with how well Microsoft is performing in future growth areas such as cloud computing. With its Azure offering, Microsoft holds a strong position just after Amazon's AWS but way ahead of Google's cloud, the number-three contender in this space. Since a low of about \$220 billion in early 2013, Microsoft's market cap more than doubled to over \$500 billion by 2017. Nonetheless, Microsoft remains below Apple, as Exhibit 5.3 shows using market cap as its metric. But Microsoft is catching up—so stay tuned! This shows again that it is difficult to gain a competitive advantage and even harder to sustain it over a prolonged period of time. *Competitive advantage is transitory!*

LIMITATIONS OF SHAREHOLDER VALUE CREATION. Although measuring firm performance through total return to shareholders and firm market capitalization has many advantages, just as with accounting profitability, it has its shortcomings:

- *Stock prices can be highly volatile, making it difficult to assess firm performance, particularly in the short term.* This volatility implies that *total return to shareholders* is a better measure of firm performance and competitive advantage over the long term

(as shown in Exhibit 5.3), because of the “noise” introduced by market volatility, external factors, and investor sentiment.

- *Overall macroeconomic factors such as economic growth or contraction, the unemployment rate, and interest and exchange rates all have a direct bearing on stock prices.* It can be difficult to ascertain the extent to which a stock price is influenced more by external macroeconomic factors (as discussed in Chapter 3) than by the firm’s strategy (see also Exhibit 3.2 highlighting firm, industry, and other effects in overall firm performance).
- *Stock prices frequently reflect the psychological mood of investors, which can at times be irrational.* Stock prices can overshoot expectations based on economic fundamentals amid periods like the internet boom, during which former Federal Reserve Chairman Alan Greenspan famously described investors’ buoyant sentiments as “irrational exuberance.”²⁰ Similarly, stock prices can undershoot expectations during busts like the 2008–2009 global financial crisis, during which investors’ sentiment was described as “irrational gloom.”²¹

ECONOMIC VALUE CREATION

The relationship between *economic value creation* and competitive advantage is fundamental in strategic management. It provides the foundation upon which to formulate a firm’s competitive strategy for cost leadership or differentiation (discussed in detail in Chapter 6). For now, it is important to note that a firm has a competitive advantage when it creates more *economic value* than rival firms. What does that mean?

Economic value created is the difference between a buyer’s willingness to pay for a product or service and the firm’s total cost to produce it. Let’s assume you consider buying a laptop computer and you have a budget of \$1,200. You have narrowed your search to two models, one offered by Firm A, the other by Firm B. Your subjective assessment of the benefits derived from owning Firm A’s laptop is \$1,000—this is the absolute maximum you’d be willing to pay for it, or the **reservation price**. For example, this could be a more or less generic, run-of-the-mill Dell laptop. In contrast, you value Firm B’s laptop model at \$1,200 because it has somewhat higher performance, is more user-friendly, and definitely has a higher “coolness factor.” Think of Apple’s MacBook Pro with Retina Display. Given that you value Firm B’s laptop by \$200 more than Firm A’s model, you will purchase a laptop from Firm B (and, in this case, end up paying as much as your reservation price allows).

Let’s move now from your individual considerations to the overall market for laptop computers in order to derive implications for firm-level competitive advantage. To simplify this illustration, only Firm A and Firm B are competing in the market for laptops. Assuming that both Firm A and Firm B have the same total unit cost of producing the particular laptop models under consideration (\$400) and the market at large has preferences similar to yours, then Firm B will have a competitive advantage. This is because Firm B creates more economic value than Firm A (by \$200), but has the same total cost, depicted in Exhibit 5.4. The amount of *total perceived consumer benefits* equals the *maximum willingness to pay*, or the *reservation price*. This amount is then split into economic value creation and the firm’s total unit cost. Firm A and Firm B have identical total unit cost, \$400 per laptop. However, Firm B’s laptop (e.g., Apple’s MacBook Pro) is perceived to provide more utility than Firm A’s laptop (e.g., Dell’s generic laptop), which implies that Firm B creates more economic value ($\$1,200 - \$400 = \$800$) than Firm A ($\$1,000 - \$400 = \600). Taken together, Firm B has a competitive advantage over Firm A because Firm B creates more economic value. This is because Firm B’s offering has greater total perceived consumer

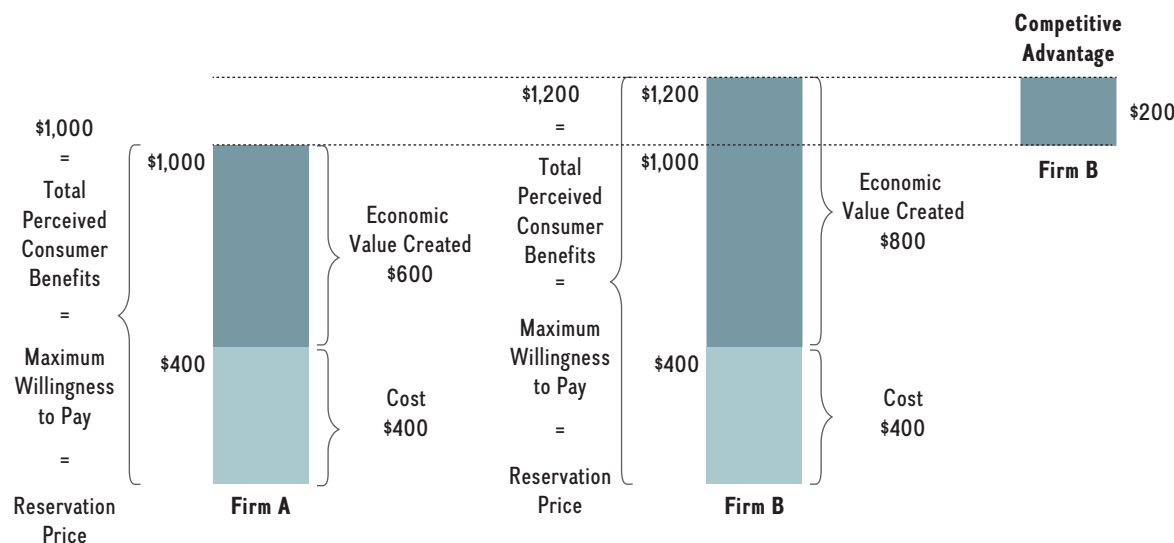
LO 5-3

Explain economic value creation and different sources of competitive advantage.

economic value created
Difference between value (V) and cost (C), or ($V - C$).

reservation price
The maximum price a consumer is willing to pay for a product or service based on the total perceived consumer benefits.

EXHIBIT 5.4 / Firm B's Competitive Advantage: Same Cost as Firm A but Firm B Creates More Economic Value

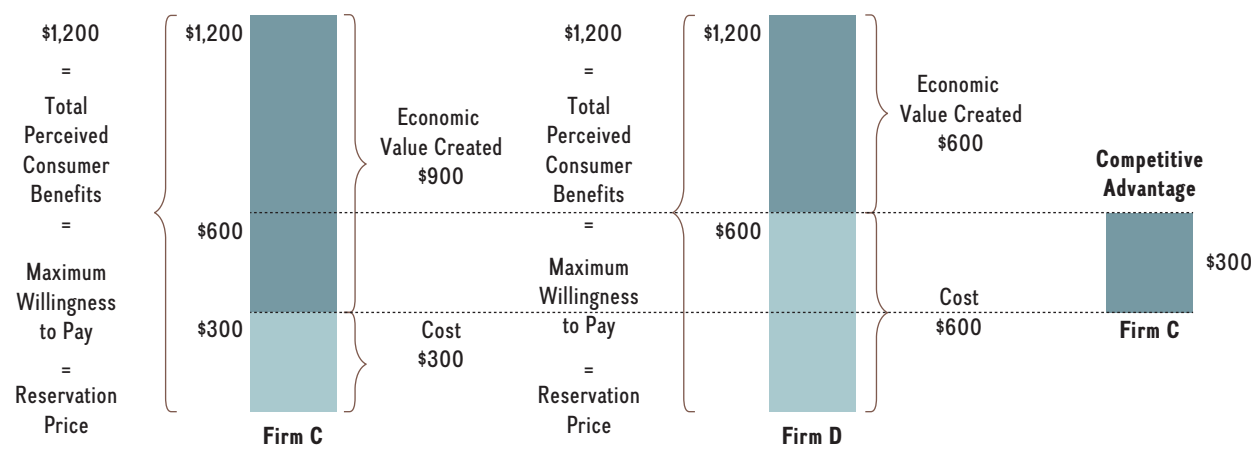


benefits than Firm A's, while the firms have the same total cost. In short, Firm B's advantage is based on superior *differentiation* leading to higher perceived value. Further, the competitive advantage can be quantified: It is \$200 (or, $\$1,200 - \$1,000$) per laptop sold for Firm B over Firm A (see Exhibit 5.4).

Exhibit 5.4 shows that Firm B's competitive advantage is based on greater economic value creation because of superior product differentiation. In addition, a firm can achieve competitive advantage through a second avenue. In particular, competitive advantage can also result from a relative *cost advantage* over rivals, assuming both firms can create the same total perceived consumer benefits.

As shown in Exhibit 5.5, two different laptop makers each offer a model that has the same perceived consumer benefits (\$1,200). Firm C, however, creates greater economic

EXHIBIT 5.5 / Firm C's Competitive Advantage: Same Total Perceived Consumer Benefits as Firm D but Firm C Creates More Economic Value



value (\$900, or $\$1,200 - \300) than that of Firm D (\$600, or $\$1,200 - \600). This is because Firm C's total unit cost (\$300) is lower than Firm D's (\$600). Firm C has a relative cost advantage over Firm D, while both products provide identical total perceived consumer benefits (\$1,200). In this example, Firm C could be Lenovo with lower cost structure than Firm D, which could be HP, but both firms offer the same value. As Exhibit 5.5 shows, Firm C has a competitive advantage over Firm D because it has lower costs. Firm C's competitive advantage over Firm D is in the amount of \$300 for each laptop sold. Here, the source of the competitive advantage is a relative cost advantage over its rival.

So far we have looked at situations in which products are priced at the maximum a consumer might be willing to pay. But markets generally don't work like that. More often, the economic value created is shared among the producer and the consumer. That is, most of the time consumers are able to purchase the product at a price point below the maximum they are willing to spend. Both the seller and the buyer benefit.

For ease in calculating competitive advantage, three components are needed. These will help us to further explain *total perceived consumer benefits* and *economic value created* in more detail:

1. Value (V)
2. Price (P)
3. Cost (C)

Value denotes the dollar amount (V) a consumer attaches to a good or service. Value captures a consumer's willingness to pay and is determined by the perceived benefits a good or service provides to the buyer. The cost (C) to produce the good or service matters little to the consumer, but it matters a great deal to the producer (supplier) of the good or service since it has a direct bearing on the profit margin.

Let's return to our laptop example from Exhibit 5.4, in which two firms sold their laptops at different prices (\$1,000 for Firm A and \$1,200 for Firm B), even though the costs were the same (\$400). In each case, the price matched the consumer's maximum willingness to pay for the particular offering. Subtracting the costs, we found that Firm A created an economic value of \$600 while Firm B created an economic value of \$800, thus achieving a competitive advantage. In most market transactions, however, some of the economic value created benefits the consumer as well.

Again, let's revisit the example depicted in Exhibit 5.4. The consumer's preference was to buy the laptop from Firm B, which she would have done because it matched her reservation price. Let's assume Firm B's laptop is actually on sale for \$1,000 (everything else remains constant). Assume the consumer again chose to purchase the laptop of Firm B rather than the one offered by Firm A (which she considered inferior). In this case, some of the economic value created by Firm B goes to the consumer. On a formula basis, total perceived value of Firm B's laptop (\$1,200) splits into *economic value created* ($V - C = \$800$) plus *total unit cost* ($C = \$400$), or: $V = (V - C) + C$.

The difference between the price charged (P) and the cost to produce (C) is the **profit**, or **producer surplus**. In the laptop example in Exhibit 5.6, if the price charged is \$1,000, the profit is $P - C = \$1,000 - \$400 = \$600$. The firm captures this amount as profit per unit sold. As the consumer, you capture the difference between what you would have been willing to pay (V) and what you paid (P), called **consumer surplus**. In our example, the consumer surplus is $V - P = \$1,200 - \$1,000$, or \$200. *Economic value creation* therefore equals *consumer surplus* plus *firm profit*, or $(V - C) = (V - P) + (P - C)$. In the laptop example:

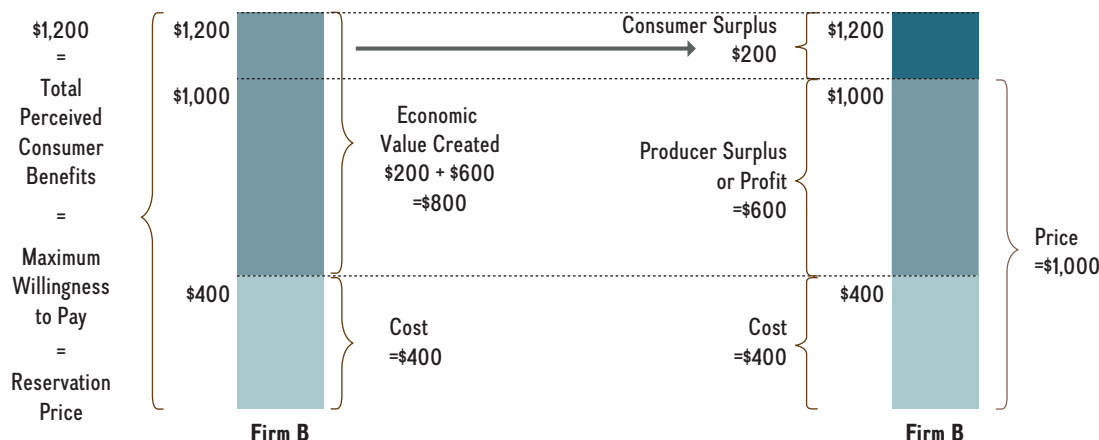
Economic value created ($\$1,200 - \400) = Consumer surplus ($\$1,200 - \$1,000$) + Producer surplus ($\$1,000 - \400) = \$200 + \$600 = \$800.

value The dollar amount (V) a consumer attaches to a good or service; the consumer's maximum willingness to pay; also called *reservation price*.

profit Difference between price charged (P) and the cost to produce (C), or $(P - C)$; also called *producer surplus*.

producer surplus Another term for profit, the difference between price charged (P) and the cost to produce (C), or $(P - C)$; also called *profit*.

consumer surplus Difference between the value a consumer attaches to a good or service (V) and what he or she paid for it (P), or $(V - P)$.

EXHIBIT 5.6 / The Role of Consumer Surplus and Producer Surplus (Profit)

The relationship between consumer and producer surplus is the reason trade happens: Both transacting parties capture *some* of the overall value created. Note, though, that the distribution of the value created between parties need not be equal to make trade worthwhile. In the example illustrated in Exhibit 5.6, the consumer surplus is \$200, while profit per unit sold is \$600.

In some cases, where firms offer highly innovative products or services, the relationship can be even more skewed. The entry-level model of the Apple Watch retailed for \$349, when introduced in 2015. And it sold well, selling twice as many watches as iPhones in each device's first year.²² An analysis by an independent engineering team, however, revealed that the firm's total cost in terms of materials and labor for the Apple Watch is no more than \$84.²³ Thus, Apple's profit for each watch sold is an estimated \$265, with a profit margin of 315 percent.

The economic value creation framework shows that strategy is about

1. Creating economic value.
2. Capturing as much of it as possible.

In contrast to Apple, consider Amazon as a counterexample: It is creating a large amount of value for its customers, but it is not capturing much, if any, of it (at this point). Amazon has had several years of negative net income as it attempts to build a stronger position in a variety of businesses. With its online retail business, Amazon.com is creating significant value for its customers (especially its Prime members) as well as third-party sellers that use its platform, but Amazon is comfortable in taking minor or no profit in doing so. Its cloud-computing service, Amazon Web Services (AWS), moreover, is also creating tremendous value for the businesses that run their computing needs on AWS, businesses including Airbnb, Comcast, Foursquare, NASA, and even the CIA (and formerly WikiLeaks), but Amazon's "profit" margin is a negative 1 to 2 percent. In fact, Amazon's comfort level appears to bear on its acquisition of Whole Foods. Even at the high end, the grocery industry has thin margins. Before Amazon acquired it, Whole Foods had been under stockholder pressure to *increase* margins by lowering *costs* for better shareholder returns. Now Whole Foods under Amazon becomes the grocery industry's worst nightmare: It can deliver negative margins and still stockholders applaud. Even if Amazon had no plans to reap synergies between in-store and online tactics, now Whole Foods becomes supercompetitive with its potential ability to lower prices.²⁴ Indeed, on its first day after closing the acquisition of Whole Foods, Amazon dropped prices at its new grocery chain by more than 30 percent on more than 100 grocery staples.

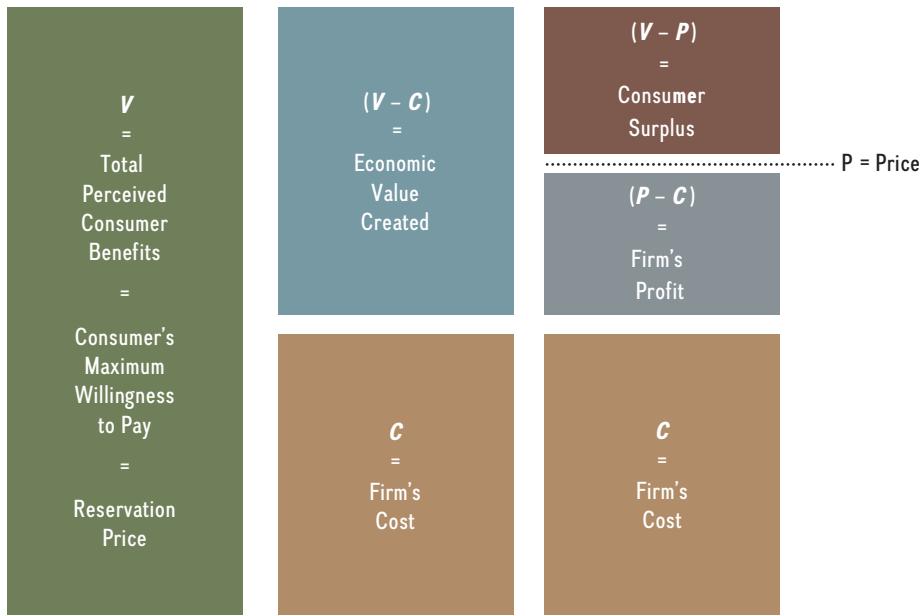


EXHIBIT 5.7 /
Competitive
Advantage and
Economic Value
Created: The Role of
Value, Cost, and Price

In this case, Amazon's customers are capturing the value that Amazon is creating. Jeff Bezos, Amazon CEO, however, is focused on long-term performance rather than short-term profitability. Amazon's investors don't seem to mind Bezos' long-term orientation, because Amazon's some \$430 billion in market cap makes it the fourth most valuable company on the planet.

Exhibit 5.7 illustrates how the components of economic value creation fit together conceptually. On the left side of the exhibit, V represents the total perceived consumer benefits, as captured in the consumer's maximum willingness to pay. In the lower part of the center bar, C is the cost to produce the product or service (the unit cost). It follows that the difference between the consumers' maximum willingness to pay and the firm's cost ($V - C$) is the economic value created. The price of the product or service (P) is indicated in the dashed line. The economic value created ($V - C$), as shown in Exhibit 5.7, is split between producer and consumer: $(V - P)$ is the value the consumer captures (*consumer surplus*), and $(P - C)$ is the value the producer captures (*producer surplus*, or *profit*).

Competitive advantage goes to the firm that achieves the largest economic value created, which is the difference between V , the consumer's willingness to pay, and C , the cost to produce the good or service. The reason is that a large difference between V and C gives the firm two distinct pricing options: (1) It can charge higher prices to reflect the higher value and thus increase its profitability, or (2) it can charge the same price as competitors and thus gain market share. Given this, the strategic objective is to maximize $V - C$, or the economic value created.

Applying the notion of *economic value creation* also has direct implications for firm financial performance. Revenues are a function of the value created for consumers and the price of the good or service, which together drive the volume of goods sold. In this perspective, profit (Π) is defined as total revenues (TR) minus total costs (TC):

$$\Pi = TR - TC, \text{ where } TR = P \times Q, \text{ or price times quantity sold}$$

Total costs include both fixed and variable costs. *Fixed costs* are independent of consumer demand—for example, the cost of capital to build computer manufacturing plants

opportunity costs

The value of the best forgone alternative use of the resources employed.

or an online retail presence to take direct orders. *Variable costs* change with the level of consumer demand—for instance, components such as different types of display screens, microprocessors, hard drives, and keyboards.

Rather than merely relying on historical costs, as done when taking the perspective of *accounting profitability* (introduced earlier), in the *economic value creation* perspective, *all costs*, including *opportunity costs*, must be considered. **Opportunity costs** capture the value of the best forgone alternative use of the resources employed.

An entrepreneur, for example, faces two types of opportunity costs: (1) forgone wages she could be earning if she was employed elsewhere and (2) the cost of capital she invested in her business, which could instead be invested in, say, the stock market or U.S. Treasury bonds. At the end of the year, the entrepreneur considers her business over the last 12 months. She made an *accounting profit* of \$70,000, calculated as total revenues minus expenses, which include all historical costs but not opportunity costs. But she also realizes she has forgone \$60,000 in salary she could have earned as an employee at another firm. In addition, she knows she could have earned \$15,000 in interest if she had bought U.S. Treasury bills with a 2 percent return instead of investing \$750,000 in her business. The opportunity cost of being an entrepreneur was \$75,000 (\$60,000 + \$15,000). Therefore, when considering all costs, including opportunity costs, she actually experienced an economic loss of \$5,000 (\$75,000 – \$70,000). When considering her future options, she should stay in business only if she values her independence as an entrepreneur more than \$5,000 per year, or thinks business will be better next year.

LIMITATIONS OF ECONOMIC VALUE CREATION. As with any tool to assess competitive advantage, the economic value creation framework also has some limitations:

- *Determining the value of a good in the eyes of consumers is not a simple task.* One way to tackle this problem is to look at consumers' purchasing habits for their revealed preferences, which indicate how much each consumer is willing to pay for a product or service. In the earlier example, the value (V) you placed on the laptop—the highest price you were willing to pay, or your reservation price—was \$1,200. If the firm is able to charge the reservation price ($P = \$1,200$), it captures all the economic value created ($V - C = \$800$) as producer surplus or profit ($P - C = \$800$).
- *The value of a good in the eyes of consumers changes based on income, preferences, time, and other factors.* If your income is high, you are likely to place a higher value on some goods (e.g., business-class air travel) and a lower value on other goods (e.g., Greyhound bus travel). In regard to preferences, you may place a higher value on a ticket for a Lady Gaga concert than on one for the New York Philharmonic (or vice versa). As an example of time value, you place a higher value on an airline ticket that will get you to an important business meeting tomorrow than on one for a planned trip to take place eight weeks from now.
- *To measure firm-level competitive advantage, we must estimate the economic value created for all products and services offered by the firm.* This estimation may be a relatively easy task if the firm offers only a few products or services. However, it becomes much more complicated for diversified firms such as General Electric or the Tata Group that may offer hundreds or even thousands of different products and services across many industries and geographies. Although the performance of individual strategic business units (SBUs) can be assessed along the dimensions described here, it becomes more difficult to make this assessment at the corporate level (more on this in our discussion of diversification strategy in Chapter 8).

The economic value creation perspective gives us one useful way to assess competitive advantage. This approach is conceptually quite powerful, and it lies at the center of many strategic management frameworks such as the generic business strategies (which we discuss in the next chapter). However, it falls somewhat short when managers are called upon to operationalize competitive advantage. When the need for “hard numbers” arises, managers and analysts frequently rely on firm financials such as *accounting profitability* or *shareholder value creation* to measure firm performance.

We’ve now completed our consideration of the three standard dimensions for measuring competitive advantage—accounting profitability, shareholder value, and economic value. Although each provides unique insights for assessing competitive advantage, one drawback is that they are more or less one-dimensional metrics. Focusing on just one performance metric when assessing competitive advantage, however, can lead to significant problems, because each metric has its shortcomings, as listed earlier. We now turn to two more conceptual and qualitative frameworks—the balanced scorecard and the triple bottom line—that attempt to provide a more holistic perspective on firm performance.

THE BALANCED SCORECARD

Just as airplane pilots rely on a number of instruments to provide constant information about key variables—such as altitude, airspeed, fuel, position of other aircraft in the vicinity, and destination—to ensure a safe flight, so should managers rely on multiple yardsticks to more accurately assess company performance in an integrative way. The **balanced scorecard** is a framework to help managers achieve their strategic objectives more effectively.²⁵ This approach harnesses multiple internal and external performance metrics in order to balance both financial and strategic goals.

Exhibit 5.8 depicts the balanced-scorecard framework. Managers using the balanced scorecard develop appropriate metrics to assess strategic objectives by answering four key questions.²⁶ Brainstorming answers to these questions ideally results in measures that give managers a quick but also comprehensive view of the firm’s current state. The four key questions are:

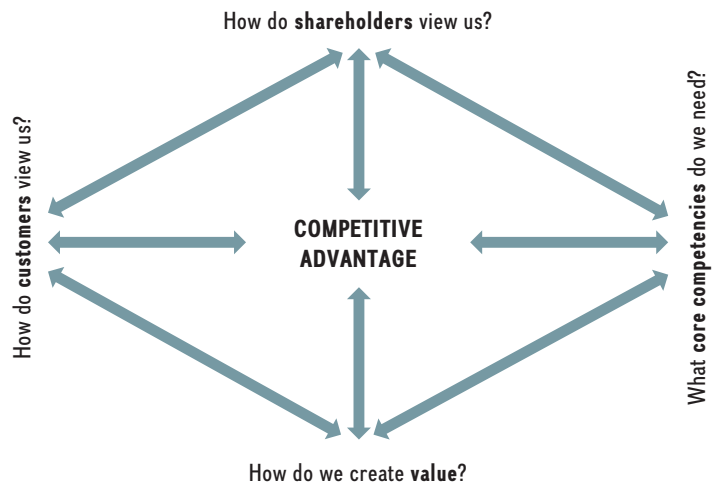
1. *How do customers view us?* The customer’s perspective concerning the company’s products and services links directly to its revenues and profits. Consumers decide their reservation price for a product or service based on how they view it. If the customer views the company’s offering favorably, she is willing to pay more for it, enhancing its competitive advantage (assuming production costs are well below the asking price). Managers track customer perception to identify areas to improve, with a focus on speed, quality, service, and cost. In the air-express industry, for example, managers learned from their customers that many don’t really need next-day delivery for most of their documents and packages; rather what they really cared about was the ability to track the shipments. This discovery led to the development of steeply discounted second-day delivery by UPS and FedEx, combined with sophisticated real-time tracking tools online.

LO 5-4

Apply a balanced scorecard to assess and evaluate competitive advantage.

balanced scorecard
Strategy implementation tool that harnesses multiple internal and external performance metrics in order to balance financial and strategic goals.

EXHIBIT 5.8 / Balanced-Scorecard Approach to Creating and Sustaining Competitive Advantage



2. *How do we create value?* Answering this question challenges managers to develop strategic objectives that ensure future competitiveness, innovation, and organizational learning. The answer focuses on the business processes and structures that allow a firm to create economic value. One useful metric is the percentage of revenues obtained from new-product introductions. For example, 3M requires that 30 percent of revenues must come from products introduced within the past four years.²⁷ A second metric, aimed at assessing a firm's external learning and collaboration capability, is to stipulate that a certain percentage of new products must originate from outside the firm's boundaries.²⁸ Through its Connect + Develop program, the consumer products company Procter & Gamble has raised the percentage of new products that originated (at least partly) from outside P&G, from 15 to 35 percent.²⁹
3. *What core competencies do we need?* This question focuses managers internally, to identify the core competencies needed to achieve their objectives and the accompanying business processes that support, hone, and leverage those competencies. As mentioned in Chapter 4, Honda's core competency is to design and manufacture small but powerful and highly reliable engines. Its business model is to find places to put its engines. Beginning with motorcycles in 1948, Honda nurtured this core competency over many decades and is leveraging it to reach stretch goals in the design, development, and manufacture of small airplanes.

Today, consumers still value reliable, gas-powered engines made by Honda. If consumers start to value electric motors more because of zero emissions, lower maintenance costs, and higher performance metrics, among other possible reasons, the value of Honda's engine competency will decrease. If this happens, then Tesla's core competency in designing and building high-powered battery packs and electric drivetrains will become more valuable. In turn, Tesla (featured in ChapterCase 1) might then be able to leverage this core competency into a strong strategic position in the emerging all-electric car and mobility industry.

4. *How do shareholders view us?* The final perspective in the balanced scorecard is the shareholders' view of financial performance (as discussed in the prior section). Some of the measures in this area rely on accounting data such as cash flow, operating income, ROIC, ROE, and, of course, total returns to shareholders. Understanding the shareholders' view of value creation leads managers to a more future-oriented evaluation.

By relying on both an internal and an external view of the firm, the balanced scorecard combines the strengths provided by the individual approaches to assessing competitive advantage discussed earlier: accounting profitability, shareholder value creation, and economic value creation.

ADVANTAGES OF THE BALANCED SCORECARD. The balanced-scorecard approach is popular in managerial practice because it has several advantages. In particular, the balanced scorecard allows managers to:

- Communicate and link the strategic vision to responsible parties within the organization.
- Translate the vision into measurable operational goals.
- Design and plan business processes.
- Implement feedback and organizational learning to modify and adapt strategic goals when indicated.

The balanced scorecard can accommodate both short- and long-term performance metrics. It provides a concise report that tracks chosen metrics and measures and compares them

to target values. This approach allows managers to assess past performance, identify areas for improvement, and position the company for future growth. Including a broader perspective than financials allows managers and executives a more balanced view of organizational performance—hence its name. In a sense, the balanced scorecard is a broad diagnostic tool. It complements the common financial metrics with operational measures on customer satisfaction, internal processes, and the company’s innovation and improvement activities.

As an example of how to implement the balanced-scorecard approach, let’s look at FMC Corp., a chemical manufacturer employing some 5,000 people in different SBUs and earning over \$3 billion in annual revenues.³⁰ To achieve its vision of becoming “the customer’s most valued supplier,” FMC’s managers initially had focused solely on financial metrics such as return on invested capital (ROIC) as performance measures. FMC is a multibusiness corporation with several standalone profit-and-loss strategic business units; its overall performance was the result of both over- and underperforming units. FMC’s managers had tried several approaches to enhance performance, but they turned out to be ineffective. Perhaps even more significant, short-term thinking by general managers was a major obstacle in the attempt to implement an effective business strategy.

Searching for improved performance, FMC’s CEO decided to adopt a balanced-scorecard approach. It enabled the managers to view FMC’s challenges and shortcomings from a holistic, company perspective, which was especially helpful to the general managers of different business units. In particular, the balanced scorecard allowed general managers to focus on market position, customer service, and product introductions that could generate long-term value. Using the framework depicted in Exhibit 5.7, general managers had to answer tough follow-up questions such as: How do we become the customer’s most valued supplier, and how can my division create this value for the customer? How do we become more externally focused? What are my division’s core competencies and contributions to the company goals? What are my division’s weaknesses?

Implementing a balanced scorecard allowed FMC’s managers to align their different perspectives to create a more focused corporation overall. General managers now review progress along the chosen metrics every month, and corporate executives do so on a quarterly basis. Implementing a balanced-scorecard approach is not a onetime effort, but requires continuous tracking of metrics and updating of strategic objectives, if needed. It is a continuous process, feeding performance back into the strategy process to assess its effectiveness (see Chapter 2).

DISADVANTAGES OF THE BALANCED SCORECARD. Though widely implemented by many businesses, the balanced scorecard is not without its critics.³¹ It is important to note that the balanced scorecard is a tool for strategy *implementation*, not for strategy *formulation*. It is up to a firm’s managers to formulate a strategy that will enhance the chances of gaining and sustaining a competitive advantage. In addition, the balanced-scorecard approach provides only limited guidance about which metrics to choose. Different situations call for different metrics. All of the three approaches to measuring competitive advantage—accounting profitability, shareholder value creation, and economic value creation—in addition to other quantitative and qualitative measures can be helpful when using a balanced-scorecard approach.

When implementing a balanced scorecard, managers need to be aware that a failure to achieve competitive advantage is not so much a reflection of a poor framework but of a strategic failure. The balanced scorecard is only as good as the skills of the managers who use it: They first must devise a strategy that enhances the odds of achieving competitive advantage. Second, they must accurately translate the strategy into objectives that they can measure and manage within the balanced-scorecard approach.³²

Once the metrics have been selected, the balanced scorecard tracks chosen metrics and measures and compares them to target values. It does not, however, provide much insight into how metrics that deviate from the set goals can be put back on track.³³

LO 5-5

Apply a triple bottom line to assess and evaluate competitive advantage.

triple bottom line

Combination of economic, social, and ecological concerns—or profits, people, and planet—that can lead to a sustainable strategy.

sustainable strategy

A strategy along the economic, social, and ecological dimensions that can be pursued over time without detrimental effects on people or the planet.

THE TRIPLE BOTTOM LINE

Today, managers are frequently asked to maintain and improve not only the firm's economic performance but also its social and ecological performance. CEO Indra Nooyi responded by declaring PepsiCo's vision to be *Performance with Purpose* defined by goals in the social dimension (*human sustainability* to combat obesity by making its products healthier, and the *whole person at work* to achieve work/life balance) and ecological dimension (*environmental sustainability* in regard to clean water, energy, recycling, and so on), in addition to firm financial performance.

Being proactive along noneconomic dimensions can make good business sense. In anticipation of coming industry requirements for "extended producer responsibility," which requires the seller of a product to take it back for recycling at the end of its life, the German carmaker BMW was proactive. It not only lined up the leading car-recycling companies but also started to redesign its cars using a modular approach. The modular parts allow for quick car disassembly and reuse of components in the after-sales market (so-called refurbished or rebuilt auto parts).³⁴ Three dimensions—*economic, social, and ecological*—make up the **triple bottom line**, which is fundamental to a sustainable strategy. These three dimensions are also called the three Ps: profits, people, and planet:

- **Profits.** The *economic dimension* captures the necessity of businesses to be profitable to survive.
- **People.** The *social dimension* emphasizes the people aspect, such as PepsiCo's initiative of the *whole person at work*.
- **Planet.** The *ecological dimension* emphasizes the relationship between business and the natural environment.

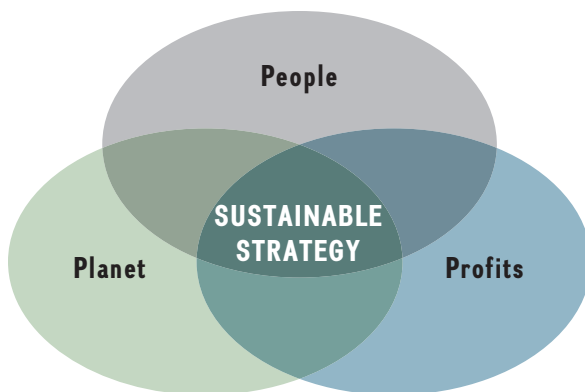
As the intersection of the three ovals (*profits, people, and planet*) in Exhibit 5.9 suggests, achieving positive results in all three areas can lead to a **sustainable strategy**. Rather than emphasizing sustaining a competitive advantage over time, *sustainable strategy* means

a strategy that can be pursued over time without detrimental effects on people or the planet. Using renewable energy sources such as wind or solar power, for example, is sustainable over time. It can also be good for profits, or simply put "green is green," as Jeffrey Immelt was fond of saying before retiring in 2017 as CEO at GE. GE's renewable energy business brought in more than \$9 billion in revenues in 2016 (up from \$3 billion in 2006).³⁵

Like the balanced scorecard, the triple bottom line takes a more integrative and holistic view in assessing a company's performance.³⁶ Using a triple-bottom-line approach, managers audit their company's fulfillment of its social and ecological obligations to stakeholders such as employees, customers, suppliers, and communities as conscientiously as they track its financial performance.³⁷ In this sense, the triple-bottom-line framework is related to *stakeholder theory*, an approach to understanding a firm as embedded in a network of internal and external constituencies that each make contributions and

EXHIBIT 5.9 / Sustainable Strategy: A Focus on the Triple Bottom Line

The simultaneous pursuit of performance along social, economic, and ecological dimensions provides a basis for a triple-bottom-line strategy.



Strategy Highlight 5.1

Interface: The World's First Sustainable Company

The Atlanta-based Interface Inc. is the world's largest manufacturer of modular carpet with annual sales of roughly \$1 billion. What makes the company unique is its strategic intent to become the world's first *fully sustainable* company. In 1994, founder Ray Anderson set a goal for the company to be "off oil" entirely by 2020. That included not using any petroleum-based raw materials or oil-related energy to fuel the manufacturing plants.

According to Collins and Porras in *Built to Last*, their classic study of high-performing companies over long periods of time, this is an example of a "BHAG—a big hairy audacious goal." BHAGs are bold missions declared by visionary companies and are a "powerful mechanism to stimulate progress."³⁸ Weaning Interface off oil by 2020 is indeed a BHAG. Many see the carpet industry as an extension of the petrochemical industry, given its heavy reliance on fossil fuels and chemicals in the manufacturing, shipping, and installation of its products.

Today, Interface is not only the global leader in modular carpet but also in sustainability. It offers innovative products such as its Cool Carpet, the world's first carbon-neutral floor

covering. Interface's customers reward it with a willingness to pay a higher price for its environmentally friendly products. The company estimates that between 1996 and 2008, it saved over \$400 million due to its energy efficiency and use of recycled materials.

Interface's business model is changing the carpet industry. Speaking of sustainability as a business model, Anderson concluded:

Sustainability has given my company a competitive edge in more ways than one. It has proven to be the most powerful marketplace differentiator I have known in my long career. Our costs are down, our profits are up, and our products are the best they have ever been. Sustainable design has provided an unexpected wellspring of innovation, people are galvanized around a shared higher purpose, better people are applying, the best people are staying and working with a purpose, the goodwill in the marketplace generated by our focus on sustainability far exceeds that which any amount of advertising or marketing expenditure could have generated—this company believes it has found a better way to a bigger and more legitimate profit—a better business model.³⁹

expect consideration in return (see the discussion in Chapter 2). For an example of how Interface, a global leader in the carpet industry, uses a triple-bottom-line approach to gain and sustain a competitive advantage, read Strategy Highlight 5.1.

5.2 Business Models: Putting Strategy into Action

Strategy is a set of goal-directed actions a firm takes to gain and sustain superior performance relative to competitors or the industry average. The translation of strategy into action takes place in the firm's **business model**, which details the firm's competitive tactics and initiatives. Simply put, the firm's business model explains how the firm intends to make money. The business model stipulates how the firm conducts its business with its buyers, suppliers, and partners.⁴⁰

How companies do business can sometimes be as important, if not more so, to gaining and sustaining competitive advantage as what they do. Indeed, a slight majority (54 percent) of senior executives responded to a recent survey stating that they consider business model innovation to be more important than process or product innovation.⁴¹ This is because product and process innovation is often more costly, is higher risk, and takes longer to come up with in the first place and to then implement. Moreover, business model innovation is often an area that is overlooked in a firm's quest for competitive advantage,

LO 5-6

Use the why, what, who, and how of business models framework to put strategy into action.

business model Stipulates how the firm conducts its business with its buyers, suppliers, and partners in order to make money.

Strategy Highlight 5.2

Threadless: Leveraging Crowdsourcing to Design Cool T-Shirts



Jacob DeHart, Jake Nickell, and Jeffrey Kalmikoff created Threadless, an online company that sells millions of dollars' worth of T-shirts annually.

©Rene Johnston/Getty Images

Threadless, an online design community and apparel store (www.threadless.com), was founded in 2000 by two students with \$1,000 as start-up capital. Jake Nickell was then at the Illinois Institute of Art and Jacob DeHart at Purdue University. After Nickell had won an online T-shirt design contest, the two entrepreneurs came up with a business model to leverage user-generated content. The idea is to let consumers “work for you” and turn consumers into *prosumers*, a hybrid between producers and consumers.

Members of the Threadless community, which is some 3 million strong, do most of the work, which they consider fun: They submit T-shirt designs online, and community members vote on which designs they like best. The designs receiving the most votes are put in production, printed, and sold online. Each Monday, Threadless releases 10 new designs and reprints more T-shirts throughout the week as inventory

is cleared out. The cost of Threadless T-shirts is a bit higher than that of competitors, about \$25.

Threadless leverages *crowdsourcing*, a process in which a group of people voluntarily perform tasks that were traditionally completed by a firm's employees. Rather than doing the work in-house, Threadless outsources its T-shirt design to its website community. The concept of leveraging a firm's own customers via internet-enabled technology to help produce better products is explicitly included in the Threadless business model. In particular, Threadless is leveraging the *wisdom of the crowds*, where the resulting decisions by many participants in the online forum are often better than decisions that could have been made by a single individual. To more effectively leverage this idea, the crowds need to be large and diverse.

At Threadless, the customers play a critical role across the entire value chain, from idea generation to design, marketing, sales forecasting, and distribution. The Threadless business model translates real-time market research and design contests into quick sales. Threadless produces only T-shirts that were approved by its community. Moreover, it has a good understanding of market demand because it knows the number of people who participated in each design contest. In addition, when scoring each T-shirt design in a contest, Threadless users have the option to check “*I'd buy it.*” These features give the Threadless community a voice in T-shirt design and also coax community members into making a purchasing commitment. Threadless does not make any significant investments until the design and market size are determined, minimizing its downside.

Not surprisingly, Threadless has sold every T-shirt that it has printed. Moreover, it has a cult-like following and is outperforming established companies American Eagle, Old Navy, and Urban Outfitters with their more formulaic T-shirt designs.⁴²

and thus much value can be unlocked by focusing on business model innovation. Strategy Highlight 5.2 takes a closer look at how the online startup Threadless uses business model innovation to gain a competitive advantage in the highly competitive apparel industry.

Perhaps most important, a firm's competitive advantage based on product innovation, such as Apple's iPhone, is less likely to be made obsolete if embedded within a business model innovation such as Apple's ecosystem of services that make users less likely to leave Apple for a competing product, even if a competitor's smartphone by itself is a better one. Indeed, Apple counts more than 530 million iPhone users embedded within its ecosystem made up of many different products and services including iTunes, iOS, App Store,

iCloud, Apple Pay, and so on. Rather than a substitute, business model innovation *complements* product and service innovation, and with it, raises the barriers to imitation. This in turn allows a firm that successfully combines product and business model innovation to extend its competitive advantage, as Apple has done for over a decade since the introduction of the iPod and iTunes business model in 2001. This radical business innovation allowed Apple to link music producers to consumers, and benefit from each transaction. Apple extended its locus of innovation from mere product innovation to how it conducts its business. That is, Apple provided a two-sided platform for exchange between producers and consumers to take place (see discussion in Chapter 7 on platform strategy for more details).

THE WHY, WHAT, WHO, AND HOW OF BUSINESS MODELS FRAMEWORK

To come up with an effective business model, a firm's managers need to transform their strategy of how to compete into a blueprint of actions and initiatives that support the overarching goals. Next, managers implement this blueprint through structures, processes, culture, and procedures. The framework shown in Exhibit 5.10 guides managers through the process of formulating and implementing a business model by asking the important questions of the why, what, who, and how. We illuminate these questions by focusing on Microsoft, also featured in ChapterCase 5.

The Microsoft example lets us see how a firm can readjust its business model responding to business challenges.

1. *Why does the business model create value?* Microsoft's new "mobile first, cloud first" business model creates value for both customers and stockholders. Customers always have the latest software, can access it anywhere, and can collaborate online with other

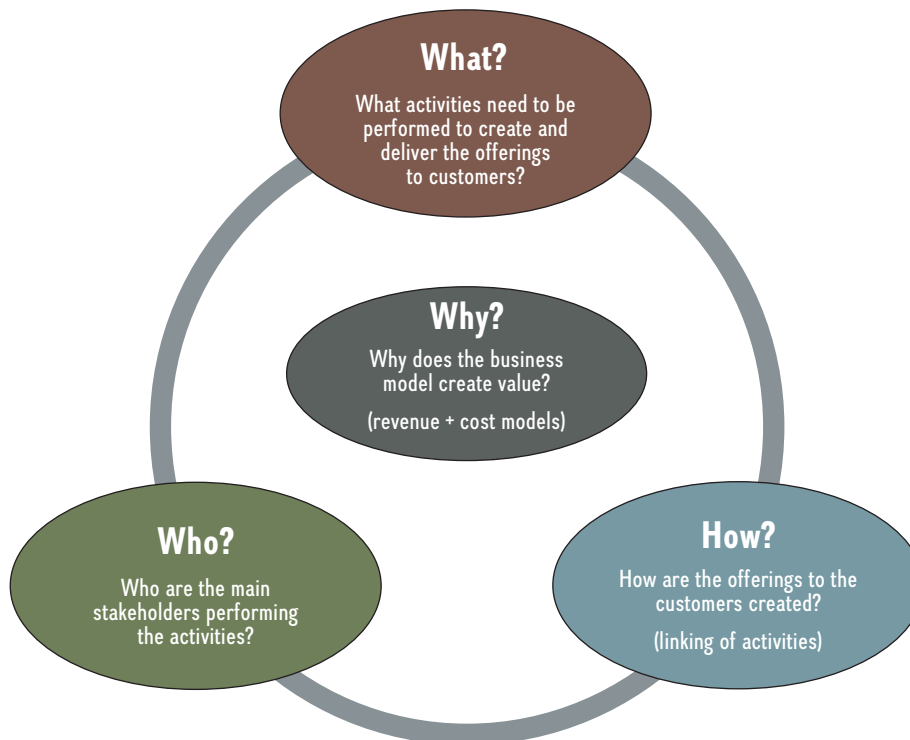


EXHIBIT 5.10 /

The Why, What, Who, and How of Business Models Framework

SOURCE: Adapted from R. Amit and C. Zott (2012), "Creating value through business model innovation," *MIT Sloan Management Review* 53, no. 3, 41–49.

users. Users no longer need to upgrade software or worry about “backward compatibility,” meaning the ability to read old (Word) files with new (Word) software. Microsoft enjoys steady revenue that over time provides greater fees than the earlier “perpetual license” model, significantly reduces the problem of software piracy, and balances the cost of ongoing support with the ongoing flow of revenues.

2. *What activities need to be performed to create and deliver the offerings to customers?* To pivot to the new “mobile first, cloud first” business model, Microsoft is making huge investments to create and deliver new offerings to its customers. The Redmond, Washington-based company needed to rewrite much of its software to be functional in a cloud-based environment. CEO Satya Nadella also decided to open the Office suite of applications to competing operating systems including Google’s Android, Apple’s iOS, and Linux, an open-source operating system. In all these activities, Microsoft’s Azure, its cloud-computing service, plays a pivotal role in its new business model.
3. *How are the offerings to the customers created?* Microsoft shifted most of its resources, including R&D and customer support, to its cloud-based offerings to not only make them best in class, but also to provide a superior user experience.
4. *Who are the main stakeholders performing the activities?* Microsoft continues to focus on both the individual end consumer as well as on more profitable business clients. Microsoft’s Azure is particularly attractive to its business customers. For example, Walmart, still the largest retailer globally with some 12,000 stores staffed by over 2 million employees and revenues of some \$500 billion, runs its cutting-edge IT logistics on Microsoft’s Azure servers, rather than Amazon’s AWS service, a major competitor to Walmart. Likewise, The Home Depot, one of the largest retailers in the United States, also uses Microsoft Azure for its computing needs.

To appreciate the value of this change in business model, we should consider for a moment the problems the change allows Microsoft to address.

- Before, with the perpetual license model, Microsoft had revenue spikes on the sale but zero revenues thereafter to support users and produce necessary updates. Now, Microsoft matches revenues to its costs and even comes out further ahead, in that after two years or so, Microsoft makes more money off a software subscription than a standalone software license.
- Before, customers had a financial disincentive to keep their software current. Now, users always have the latest software, can access it anywhere, and can collaborate online with other users without worries about backward compatibility.
- Perhaps most impressively, the new model deals effectively with software piracy. Before, Microsoft suffered tremendous losses through software piracy. This affects consumers too, as the cost of piracy is borne by legal consumers to a large degree. Now, pirating cloud-based software is much more difficult, because Microsoft can easily monitor how many users (based on unique internet protocol [IP] addresses) are using the same log-in information at different locations and perhaps even at the same time. Once the provider suspects piracy, it tends to disable the accounts as this goes against the terms of service agreed upon when purchasing the software, not to mention that copyright infringements are illegal. Indeed, the scope of the piracy problem is driven home by the survey-based claim that some 60 percent of computer users confess to pirating software.⁴³

POPULAR BUSINESS MODELS

Given their critical importance to achieving competitive advantage, business models are constantly evolving. Below we will discuss some of the more popular business models:⁴⁴

- Razor–razor-blades
- Subscription
- Pay-as-you-go
- Freemium
- Wholesale
- Agency
- Bundling

Understanding the more popular business models today will increase the tools in your strategy toolkit.

- **Razor–razor-blades.** The initial product is often sold at a loss or given away for free to drive demand for complementary goods. The company makes its money on the replacement part needed. As you might guess, it was invented by Gillette, which gave away its razors and sold the replacement cartridges for relatively high prices. The razor–razor-blade model is found in many business applications today. For example, HP charges little for its laser printers but imposes high prices for its replacement toner cartridges.
- **Subscription.** The subscription model has been traditionally used for print magazines and newspapers. Users pay for access to a product or service whether they use the product or service during the payment term or not. Microsoft uses a subscription-based model for its new Office 365 suite of application software. Other industries that use this model presently are cable television, cellular service providers, satellite radio, internet service providers, and health clubs. Netflix also uses a subscription model.
- **Pay-as-you-go.** In the *pay-as-you-go business model*, users pay for only the services they consume. The pay-as-you-go model is most widely used by utilities providing power and water and cell phone service plans, but it is gaining momentum in other areas such as rental cars and cloud computing such as Microsoft’s Azure. News providers such as *The New York Times* and *The Wall Street Journal* have created “pay walls” as a pay-as-you-go option.
- **Freemium.** The *freemium (free + premium) business model* provides the basic features of a product or service *free* of charge, but charges the user for *premium* services such as advanced features or add-ons.⁴⁵ For example, companies may provide a minimally supported version of their software as a trial (e.g., business application or video game) to give users the chance to try the product. Users later have the option of purchasing a supported version of software, which includes a full set of product features and product support. An ultra low-cost business model is quite similar to freemium: a model in which basic service is provided at a low cost and extra items are sold at a premium. The business pursuing this model has the goal of driving down costs. Examples include Spirit Airlines (in the United States), Ryanair (in Europe), or AirAsia, which provide minimal flight services but allow customers to pay for additional services and upgrades à la carte, often at a premium.
- **Wholesale.** The traditional model in retail is called a *wholesale model*. Let’s look at the book publishing industry as an example. Under the wholesale model, book publishers would sell books to retailers at a fixed price (usually 50 percent below the recommended retail price). Retailers, however, were free to set their own price on any book and profit from the difference between their selling price and the cost to buy the book from the publisher (or wholesaler).
- **Agency.** In this model the producer relies on an agent or retailer to sell the product, at a predetermined percentage commission. Sometimes the producer will also control the retail price. The *agency model* was long used in the entertainment industry, where

agents place artists or artistic properties and then take their commission. More recently we see this approach at work in a number of online sales venues, as in Apple's pricing of book products or its app sales. (See further discussion following.)

- **Bundling.** The *bundling* business model sells products or services for which demand is negatively correlated *at a discount*. Demand for two products is negatively correlated if a user values one product more than another. In the Microsoft Office Suite, a user might value Word more than Excel and vice versa. Instead of selling both products for \$120 each, Microsoft bundles them in a suite and sells them combined at a discount, say \$150. This bundling strategy allowed Microsoft to become the number-one provider of all major application software packages such as word processing, spreadsheets, slide show presentation, and so on. Before its bundling strategy, Microsoft faced strong competition in each segment. Indeed, Word Perfect was outselling Word, Lotus 1-2-3 was outselling Excel, and Harvard Graphics was outselling PowerPoint. The problem for Microsoft's competitors was that they did not control the operating system (Windows), which made their programs less seamless on this operating system. In addition, the competitor products to Microsoft were offered by three independent companies, so they lacked the option to bundle them at a discount.

DYNAMIC NATURE OF BUSINESS MODELS

Business models evolve dynamically, and we can see many combinations and permutations. Sometimes business models are tweaked to respond to disruptions in the market, efforts that can conflict with fair trade practices and may even prompt government intervention.

COMBINATION. Telecommunications companies such as AT&T or Verizon, to take one industry, combine the *razor-razor-blade* model with the *subscription* model. They frequently provide a basic cell phone at no charge, or significantly subsidize a high-end smartphone, when you sign up for a two-year wireless service plan. Telecom providers recoup the subsidy provided for the smartphone by requiring customers to sign up for lengthy service plans. This is why it is so critical for telecom providers to keep their *churn rate*—the proportion of subscribers that leave, especially before the end of the contractual term—as low as possible.

EVOLUTION. The *freemium* business model can be seen as an evolutionary variation on the *razor-razor-blade* model. The base product is provided free, and the producer finds other ways to monetize the usage. The freemium model is used extensively by open-source software companies (e.g., Red Hat), mobile app companies, and other internet businesses. Many of the free versions of applications include advertisements to make up for the cost of supporting nonpaying users. In addition, the paying premium users subsidize the free users. The freemium model is often used to build a consumer base when the marginal cost of adding another user is low or even zero (such as in software sales). Many online video games, including massive multiplayer online games and app-based mobile games, follow a variation of this model, allowing basic access to the game for free, but charging for power-ups, customizations, special objects, and similar things that enhance the game experience for users.

DISRUPTION. When introducing the *agency* model, we mentioned Apple and book publishing, and you may already know how severely Amazon disrupted the traditional wholesale model for publishers. Amazon took advantage of the pricing flexibility inherent in the wholesale model and offered many books (especially e-books) below the cost that other retailers had to pay to publishers. In particular, Amazon would offer newly released best-sellers, such as Dan Brown's novels, for \$9.99 to promote its Kindle e-reader. Publishers

and other retailers strongly objected because Amazon's retail price was lower than the wholesale price paid by retailers competing with Amazon. Moreover, the \$9.99 e-book offer by Amazon made it untenable for other retailers to continue to charge \$28.95 for newly released hardcover books (for which they had to pay \$14 to \$15 to the publishers). With its aggressive pricing, Amazon not only devalued the printed book, but also lost money on every book it sold. It did this to increase the number of users of its Kindle e-readers and tablets.

RESPONSE TO DISRUPTION. The market is dynamic, and in the above example, book publishers looked for another model. Many book publishers worked with Apple on an agency approach, in which the publishers would set the price for Apple and receive 70 percent of the revenue, while Apple received 30 percent. The approach is similar to the Apple App Store pricing model for iOS applications in which developers set a price for applications and Apple retains a percentage of the revenue.

Use of the agency model was intended to give publishers the leverage to raise e-book prices for retailers. Under the agency model, publishers could increase their e-book profits and price e-books more closely to prices of printed books. Publishers inked their deals with Apple, but how could they get Amazon to play ball? For leverage, publishers withheld new releases from Amazon. This forced Amazon to raise prices on newly released e-books in line with the agency model to around \$14.95.

LEGAL CONFLICTS. The rapid development of business models, especially in response to disruption, can lead producers to breach existing rules of commerce. In the above example, the publishers' response prompted an antitrust investigation. In 2012 the Department of Justice determined that Apple and major publishers had conspired to raise prices of e-books. To settle the legal action, each publisher involved negotiated new deals with retailers, including Amazon. A year later, Apple was found guilty of colluding with several major book publishers to fix prices on e-books and had to change its agency model.⁴⁶

5.3 Implications for Strategic Leaders

In this chapter, we discussed how to measure and assess competitive advantage using three traditional approaches: accounting profitability, shareholder value creation, and economic value creation. We then introduced two conceptual frameworks to help us understand competitive advantage in a more holistic fashion: the balanced scorecard and the triple bottom line. Exhibit 5.11 summarizes the concepts discussed.

EXHIBIT 5.11 / How to Measure and Assess Competitive Advantage

Competitive advantage is reflected in superior firm performance.

- We always assess competitive advantage *relative* to a benchmark, either using competitors or the industry average.
- Competitive advantage is a multifaceted concept.
- We can assess competitive advantage by measuring accounting profit, shareholder value, or economic value.
- The balanced-scorecard approach harnesses multiple internal and external performance dimensions to balance a firm's financial and strategic goals.
- More recently, competitive advantage has been linked to a firm's triple bottom line, the ability to maintain performance in the economic, social, and ecological contexts (profits, people, planet) to achieve a sustainable strategy.

Several managerial implications emerged from our discussion of competitive advantage and firm performance:

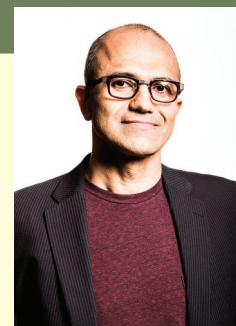
- No *best* strategy exists—only *better* ones (better in comparison with others). We must interpret any performance metric relative to those of competitors and the industry average. True performance can be judged only in comparison to other contenders in the field or the industry average, not on an absolute basis.
- The goal of strategic management is to integrate and align each business function and activity to obtain superior performance at the business unit and corporate levels. Therefore, competitive advantage is best measured by criteria that reflect *overall business unit performance* rather than the performance of specific departments. For example, although the functional managers in the marketing department may (and should) care greatly about the success or failure of their recent ad campaign, the *general* manager cares most about the performance implications of the ad campaign at the business-unit level for which she has profit-and-loss responsibility. Metrics that aggregate upward and reflect overall firm and corporate performance are most useful to assess the effectiveness of a firm's competitive strategy.
- Both *quantitative and qualitative* performance dimensions matter in judging the effectiveness of a firm's strategy. Those who focus on only one metric will risk being blindsided by poor performance on another. Rather, managers need to rely on a more holistic perspective when assessing firm performance, measuring different dimensions over different time periods.
- A firm's business model is critical to achieving a competitive advantage. How a firm does business is as important as what it does.

This concludes our discussion of competitive advantage, firm performance, and business models, and completes Part 1—strategy analysis—of the AFI framework. In Part 2, we turn our attention to the next steps in the AFI framework—strategy formulation. In Chapters 6 and 7, we focus on business strategy: How should the firm compete (cost leadership, differentiation, or value innovation)? In Chapters 8 and 9, we study corporate strategy: Where should the firm compete (industry, markets, and geography)? Chapter 10 looks at global strategy: How and where (local, regional, national, and international) should the firm compete around the world?

CHAPTERCASE 5 / Consider This . . .

GIVEN MICROSOFT'S LACKLUSTER performance since 2000, the once dominant company is now in turnaround mode. Over time, its competitive advantage turned into a competitive disadvantage, lagging behind Apple by a wide margin. Satya Nadella's strategic focus is to move Microsoft away from its Windows-only business model to compete more effectively in a "mobile first, cloud first world," the mantra he used in his appointment e-mail as CEO. Under his leadership, Microsoft made the Office Suite available on Apple iOS and Android mobile devices. Office 365, its cloud-based

software offering, is now available as a subscription service starting at \$6.99 per month for personal use and \$69.99 for business use. Software applications can be accessed on any device, any time, with online storage, combined with Skype's global calling feature. Yet, Nadella needs to work



Satya Nadella, Microsoft CEO.

©Brian Smale/Microsoft/
Getty Images

hard to ensure Microsoft's future viability because Windows and Office were cash cows for so long. They are still generating 40 percent of revenues and some 75 percent of profits, but both continue to decline. The problem he faces is that the gross margin of "classic" PC-based Office is 90 percent (due to Microsoft's "monopoly" position), while the gross margin for Office 365 is only around 50 percent. The cloud computing space with Amazon, Alphabet (Google), Apple, IBM, and others is fiercely competitive.⁴⁷

Questions

1. Why is it so hard to gain a competitive advantage? Why is it even harder to sustain a competitive advantage?
2. Looking at the different ways to assess competitive advantage discussed in this chapter, does Microsoft

have a competitive advantage over Apple using any of the approaches? Why or why not? In which approach is Microsoft looking "the best"? Explain.

3. Microsoft CEO Satya Nadella has made drastic changes to Microsoft's strategy. What was Microsoft's strategy before Nadella was appointed CEO in 2014? What is it now under his leadership? Do you agree that Nadella has formulated a promising business model? Why or why not?
4. How much longer do you think Apple can sustain its competitive advantage (not just over Microsoft, but in general)? Explain.

NOTE: A financial ratio review related to this ChapterCase is available in Connect.

TAKE-AWAY CONCEPTS

This chapter demonstrated three traditional approaches for assessing and measuring firm performance and competitive advantage, as well as two conceptual frameworks designed to provide a more holistic, albeit more qualitative, perspective on firm performance. We also discussed the role of business models in translating a firm's strategy into actions.

LO 5-1 / Conduct a firm profitability analysis using accounting data to assess and evaluate competitive advantage.

- To measure competitive advantage, we must be able to (1) accurately assess firm performance, and (2) compare and benchmark the focal firm's performance to other competitors in the same industry or the industry average.
- To measure accounting profitability, we use standard metrics derived from publicly available accounting data.
- Commonly used profitability metrics in strategic management are *return on assets (ROA)*, *return on equity (ROE)*, *return on invested capital (ROIC)*, and *return on revenue (ROR)*. See the key financial ratios in five tables in the "How to Conduct a Case Analysis" guide.

- All accounting data are historical and thus backward-looking. They focus mainly on tangible assets and do not consider intangibles that are hard or impossible to measure and quantify, such as an innovation competency.

LO 5-2 / Apply shareholder value creation to assess and evaluate competitive advantage.

- Investors are primarily interested in total return to shareholders, which includes stock price appreciation plus dividends received over a specific period.
- Total return to shareholders is an external performance metric; it indicates how the market views all publicly available information about a firm's past, current state, and expected future performance.
- Applying a shareholders' perspective, key metrics to measure and assess competitive advantage are the return on (risk) capital and market capitalization.
- Stock prices can be highly volatile, which makes it difficult to assess firm performance. Overall macroeconomic factors have a direct bearing on stock prices. Also, stock prices frequently reflect the psychological mood of the investors, which can at times be irrational.

- Shareholder value creation is a better measure of competitive advantage over the *long term* due to the “noise” introduced by market volatility, external factors, and investor sentiment.

LO 5-3 / Explain economic value creation and different sources of competitive advantage.

- The relationship between economic value creation and competitive advantage is fundamental in strategic management. It provides the foundation upon which to formulate a firm’s competitive strategy of cost leadership or differentiation.
- Three components are critical to evaluating any good or service: value (*V*), price (*P*), and cost (*C*). In this perspective, cost includes opportunity costs.
- Economic value created is the difference between a buyer’s willingness to pay for a good or service and the firm’s cost to produce it ($V - C$).
- A firm has a competitive advantage when it is able to create more economic value than its rivals. The source of competitive advantage can stem from higher perceived value creation (assuming equal cost) or lower cost (assuming equal value creation).

LO 5-4 / Apply a balanced scorecard to assess and evaluate competitive advantage.

- The balanced-scorecard approach attempts to provide a more integrative view of competitive advantage.
- Its goal is to harness multiple internal and external performance dimensions to balance financial and strategic goals.
- Managers develop strategic objectives for the balanced scorecard by answering four key questions: (1) How do customers view us? (2) How do we create value? (3) What core competencies do we need? (4) How do shareholders view us?

LO 5-5 / Apply a triple bottom line to assess and evaluate competitive advantage.

- Noneconomic factors can have a significant impact on a firm’s financial performance,

not to mention its reputation and customer goodwill.

- Managers are frequently asked to maintain and improve not only the firm’s economic performance but also its social and ecological performance.
- Three dimensions—economic, social, and ecological, also known as *profits*, *people*, and *planet*—make up the triple bottom line. Achieving positive results in all three areas can lead to a sustainable strategy—a strategy that can endure over time.
- A sustainable strategy produces not only positive financial results, but also positive results along the social and ecological dimensions.
- Using a triple-bottom-line approach, managers audit their company’s fulfillment of its social and ecological obligations to stakeholders such as employees, customers, suppliers, and communities in as serious a way as they track its financial performance.
- The triple-bottom-line framework is related to stakeholder theory, an approach to understanding a firm as embedded in a network of internal and external constituencies that each make contributions and expect consideration in return.

LO 5-6 / Use the why, what, who, and how of business models framework to put strategy into action.

- The translation of a firm’s strategy (*where and how to compete for competitive advantage*) into action takes place in the firm’s business model (*how to make money*).
- A business model details how the firm conducts its business with its buyers, suppliers, and partners.
- How companies do business is as important to gaining and sustaining competitive advantage as what they do.
- The why, what, who, and how framework guides managers through the process of formulating and implementing a business model.

KEY TERMS

Balanced scorecard (p. 161)

Business model (p. 165)

Consumer surplus (p. 157)

Economic value created (p. 165)

Market capitalization (p. 153)

Opportunity costs (p. 160)

Producer surplus (*p. 157*)
 Profit (*p. 157*)
 Reservation price (*p. 155*)

Risk capital (*p. 153*)
 Shareholders (*p. 153*)
 Sustainable strategy (*p. 164*)

Total return to shareholders (*p. 153*)
 Triple bottom line (*p. 164*)
 Value (*p. 157*)

DISCUSSION QUESTIONS

- Domino's Pizza has been in business more than 50 years and claims to be "#1 Worldwide in Pizza Delivery" with over 13,000 locations. Visit the company's business-related website (www.biz.dominos.com) and read the "our strengths" section under the "Investors/Profile" tab. Does the firm focus on the accounting, shareholder, or economic perspective in describing its competitive advantage?
- For many people, the shareholder perspective is perhaps the most familiar measure of competitive advantage for publicly traded firms. What are some of the disadvantages of using shareholder value as the sole point of view for defining competitive advantage?
- Interface, Inc., is discussed in Strategy Highlight 5.1. It may seem unusual for a business-to-business carpet company to be using a triple-bottom-line approach for its strategy. What other industries do you think could productively use this approach? How would it change customers' perceptions if it did?

ETHICAL/SOCIAL ISSUES

- You work as a supervisor in a manufacturing firm. The company has implemented a balanced-scorecard performance-appraisal system and a financial bonus for exceeding goals. A major customer order for 1,000 units needs to ship to a destination across the country by the end of the quarter, which is two days away from its close. This shipment, if it goes well, will have a major impact on both your customer-satisfaction goals and your financial goals.
 With 990 units built, a machine breaks. It will take two days to get the parts and repair the machine. You realize there is an opportunity to load the finished units on a truck tomorrow with paperwork for the completed order of 1,000 units. You can have an employee fly out with the 10 remaining parts and meet the truck at the destination city once the machinery has been repaired. The 10 units can be added to the pallet and delivered as a complete shipment of 1,000 pieces, matching the customer's order and your paperwork. What do you do?
- How do the perspectives on competitive advantage differ when comparing brick-and-mortar stores to online businesses (e.g., Best Buy versus Amazon, Barnes & Noble versus Amazon, Old Navy versus Threadless [noted in Strategy Highlight 5.2], Nordstrom versus Zappos, and so on)? Make recommendations to brick-and-mortar stores as to how they can compete more effectively with online firms. What conclusions do you draw?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

As discussed in the chapter, a balanced scorecard views the performance of an organization through four lenses: customer, innovation and learning, internal

business, and financial. According to surveys from consulting firm Bain & Co., about 60 percent of firms in both public and private sectors have used a balanced scorecard for performance measures.⁴⁸

With your group, create a balanced scorecard for the business school at your university. You might start by looking at your school's web page for a mission or vision statement. Then divide up the four perspectives among the team members to develop key elements for each one. It may be helpful to remember the four key balanced-scorecard questions from the chapter:

1. How do customers view us? (Hint: First discuss the following: Who are the customers? The students? The companies that hire students? Others?)
2. How do we create value?
3. What core competencies do we need?
4. How do shareholders view us? (For public universities, the shareholders are the taxpayers who invest their taxes in the university. For private universities, the shareholders are the people or organizations that endow the university.)

Small Group Exercise 2

At the next big family gathering, you want to impress your grandparents with the innovative ideas you have learned in business school. They have decades of experience in investing in the stock market and, from their college days, believe that economic profitability is a business's primary responsibility. You would like to convince them that a triple-bottom-line approach is the modern path to stronger economic performance. With your group members, prepare a casual yet informative pitch you can use to persuade them. They probably will not listen for more than two minutes, so you know you have to be clear and concise with interesting examples. You may want to reinforce your argument by consulting "The Bottom Line of Corporate Good," published in *Forbes*.⁴⁹ Present your speech in whatever way your instructor requests—to your group, to the entire class, or in an online video.

mySTRATEGY

How Much Is an MBA Worth to You?

The myStrategy box at the end of Chapter 1 asked how much you would be willing to pay for the job you want—for a job that reflects your values. Here, we look at a different issue relating to worth: How much is an MBA worth over the course of your career?

Alongside the traditional two-year full-time MBA program, many business schools also offer evening MBAs and executive MBAs. Let's assume you know you want to pursue an advanced degree, and you need to decide which program format is better

for you (or you want to evaluate the choice you already made). You've narrowed your options to either (1) a two-year full-time MBA program, or (2) an executive MBA program at the same institution that is 18 months long with classes every other weekend. Let's also assume the price for tuition, books, and fees is \$30,000 for the full-time program and \$90,000 for the executive MBA program.

Which MBA program should you choose? Consider in your analysis the value, price, and cost concepts discussed in this chapter. Pay special attention to opportunity costs attached to different MBA program options.

ENDNOTES

1. For an in-depth discussion of Apple, see: Rothaermel, F.T., (2017), "Apple Inc.," Case MHE-FTR-051-1259927628, <http://create.mheducation.com/>; "Microsoft at middle age: Opening Windows," *The Economist*, April 4, 2015; "What Satya Nadella did at Microsoft," *The Economist*, March 16, 2017; and Mochhizuki, T. (2017, Feb. 28), "Apple's next iPhone will have a curved screen," *The Wall Street Journal*.

2. This debate takes place in the following discourses, among others: Misangyi, V.F., H. Elms, T. Greckhamer, and J.A. Lepine (2006), "A new perspective on a fundamental debate: A multilevel approach to industry, corporate, and business unit effects," *Strategic Management Journal* 27: 571–590; McNamara, G., F. Aime, and P. Vaaler (2005), "Is performance driven by industry- or firm-specific factors? A reply to Hawawini, Subramanian, and Verdin," *Strategic Management Journal* 26:

1075–1081; Hawawini, G., V. Subramanian, and P. Verdin (2005), "Is performance driven by industry- or firm-specific factors? A new look at the evidence: A response to McNamara, Aime, and Vaaler," *Strategic Management Journal* 26: 1083–1086; Rumelt, R.P. (2003), "What in the world is competitive advantage?" *Policy Working Paper 2003-105*; McGahan, A.M., and M.E. Porter (2002), "What do we know about variance in accounting profitability?" *Management Science* 48:

834–851; Hawawini, G., V. Subramanian, and P. Verdin (2003), “Is performance driven by industry- or firm-specific factors? A new look at the evidence,” *Strategic Management Journal* 24: 1–16; McGahan, A.M., and M.E. Porter (1997), “How much does industry matter, really?” *Strategic Management Journal* 18: 15–30; Rumelt, R.P. (1991), “How much does industry matter?” *Strategic Management Journal* 12: 167–185; Porter, M.E. (1985), *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press); and Schmalensee, R. (1985), “Do markets differ much?” *American Economic Review* 75: 341–351;

3. Rumelt, R.P. (2003), “What in the world is competitive advantage?” *Policy Working Paper 2003-105*.

4. For discussion see: McGahan, A.M., and M. E. Porter (2002), “What do we know about variance in accounting profitability?” *Management Science*, 48: 834–851.

5. (*Net profits / Invested capital*) is shorthand for (*Net operating profit after taxes [NOPAT] / Total stockholders’ equity + Total debt – Value of preferred stock*). See discussion of profitability ratios in Table 1, “When and How to Use Financial Measures to Assess Firm Performance,” of the “How to Conduct a Case Analysis” the guide to conducting a case analysis that concludes Part 4 of the text.

6. The data for this section are drawn from Apple and Microsoft annual reports (various years) and a number of news articles, including: Dou, E. (2017, Feb. 1), “Cheaper rivals eat away at Apple sales in China,” *The Wall Street Journal*; “What Satya Nadella did at Microsoft,” *The Economist*, March 16, 2016; and “iPhone, therefore I am,” *The Economist*, January 30, 2016.

7. This example is based on the 2016 SEC 10-K reports for Apple and Microsoft. Connect provides the financial analysis conducted here as an exercise for a five-year time period, 2012–2016. This allows for more dynamic considerations.

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PART

2 Formulation

CHAPTER 6 Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

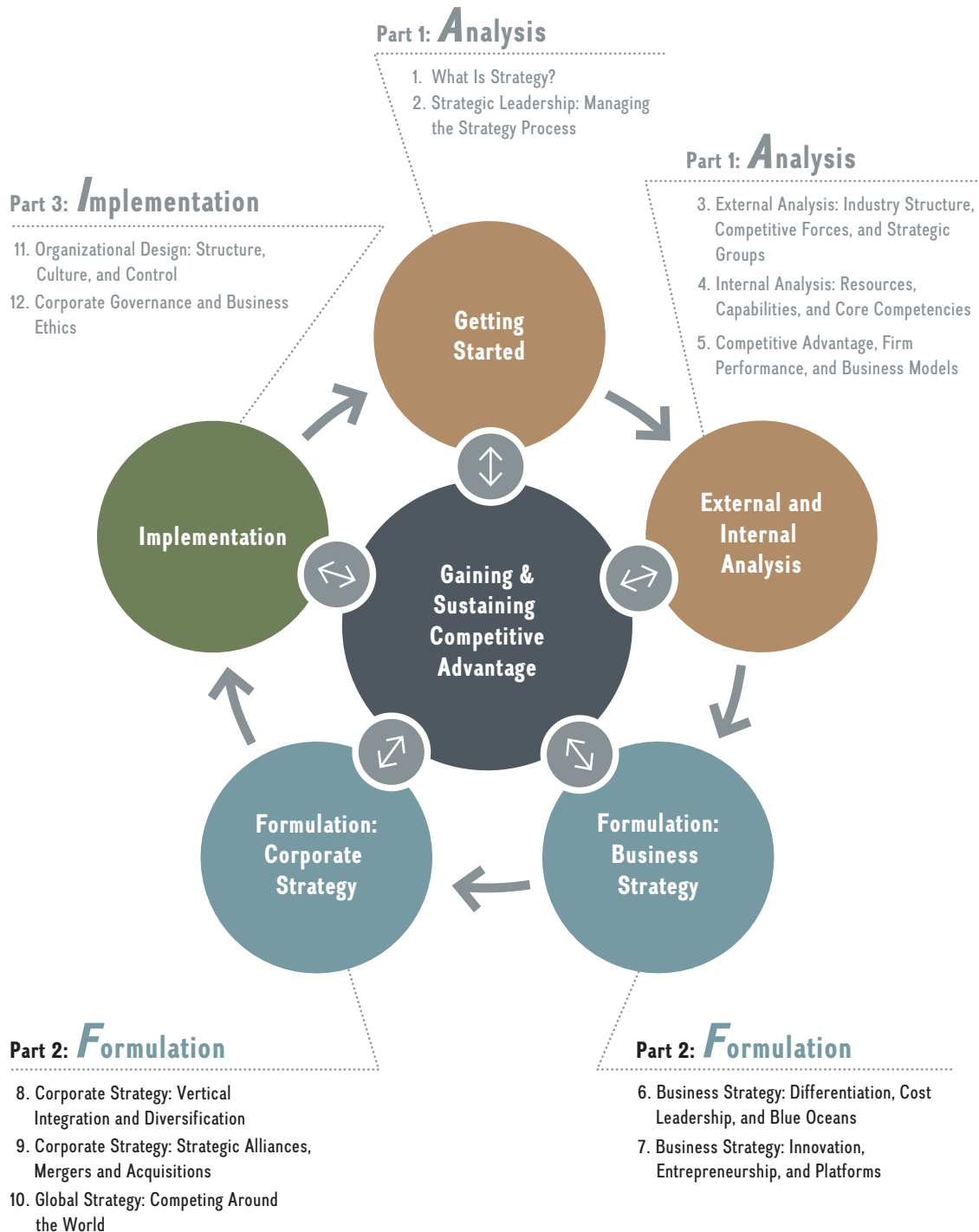
CHAPTER 7 Business Strategy: Innovation, Entrepreneurship, and Platforms

CHAPTER 8 Corporate Strategy: Vertical Integration and Diversification

CHAPTER 9 Corporate Strategy: Strategic Alliances, Mergers and Acquisitions

CHAPTER 10 Global Strategy: Competing Around the World

The AFI Strategy Framework



CHAPTER 6 Business Strategy: Differentiation, Cost Leadership, and Blue Oceans

Chapter Outline

- 6.1 Business-Level Strategy: How to Compete for Advantage**
 - Strategic Position*
 - Generic Business Strategies*
- 6.2 Differentiation Strategy: Understanding Value Drivers**
 - Product Features*
 - Customer Service*
 - Complements*
- 6.3 Cost-Leadership Strategy: Understanding Cost Drivers**
 - Cost of Input Factors*
 - Economies of Scale*
 - Learning Curve*
 - Experience Curve*
- 6.4 Business-Level Strategy and the Five Forces: Benefits and Risks**
 - Differentiation Strategy: Benefits and Risks*
 - Cost-Leadership Strategy: Benefits and Risks*
- 6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership**
 - Value Innovation*
 - Blue Ocean Strategy Gone Bad: "Stuck in the Middle"*
- 6.6 Implications for Strategic Leaders**

Learning Objectives

- LO 6-1** Define business-level strategy and describe how it determines a firm's strategic position.
- LO 6-2** Examine the relationship between value drivers and differentiation strategy.
- LO 6-3** Examine the relationship between cost drivers and cost-leadership strategy.
- LO 6-4** Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.
- LO 6-5** Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.
- LO 6-6** Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

JetBlue Airways: Finding a New Blue Ocean?

WHEN JETBLUE AIRWAYS took to the skies, founder David Neeleman set out to pursue a blue ocean strategy. This type of competitive strategy combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs in those two distinct strategic positions. How is this done, and where did Neeleman's ideas come from?

At the age of 25, the young entrepreneur co-founded Morris Air, a charter air service that in 1993 was purchased by Southwest Airlines (SWA). Morris Air was a low-fare airline that pioneered many cost-saving practices that later became standard in the industry, such as e-ticketing. After working as an airline executive for SWA, Neeleman went on to launch JetBlue in 2000. When Neeleman established JetBlue, his strategy was to provide

air travel at even lower costs than SWA. At the same time, he wanted to offer better service and more amenities than the legacy carriers such as American, Delta, or United. To sum it up, JetBlue's Customer Bill of Rights declares its dedication to bringing humanity back to air travel.

To implement a blue ocean strategy, JetBlue focused on lowering operating costs while driving up perceived customer value in its service offerings. In particular, JetBlue copied and improved upon many of SWA's cost-reducing activities. It initially used just one type of airplane (the Airbus A-320) to lower the costs of aircraft maintenance and pilot and crew training. It also chose to fly point to point, directly connecting highly trafficked city pairs. JetBlue specialized in transcontinental flights

connecting the East Coast (e.g., from its home base in New York) to the West Coast (e.g., Los Angeles). In contrast, legacy airlines such as American, Delta, or United use a hub-and-spoke system. This type of operating model connects many different locations via layovers at airport hubs. The point-to-point model focuses on directly connecting fewer but more highly trafficked city pairs. This model lowers costs by not offering baggage transfers and schedule coordination with other airlines. In addition, JetBlue flies longer distances and transports more passengers per flight than SWA, further driving down its costs. Initially, JetBlue enjoyed the lowest cost per available seat-mile (an

important performance metric in the airline industry) in the United States.

At the same time, JetBlue also enhanced its differential appeal by driving up its perceived value. Its mantra was to combine high-touch—to enhance the customer experience—and high-tech—to drive down costs. Because roughly one-third of customers prefer speaking to a live reservation agent, despite a highly functional website for reservations and other



JetBlue offers its Mint luxury experience, which includes a lie-flat bed up to 6 feet 8 inches long, a high-resolution personal screen, and free in-flight high-speed Wi-Fi, on many domestic U.S. routes. Other U.S. competitors offer such amenities only on very few routes.

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travel-related services, JetBlue decided to use work-from-home employees in the United States instead of following industry best practice by outsourcing its reservation system. Some of JetBlue's other value-enhancing features include high-end 100-seat Embraer regional jets with leather seats, free movie and television programming via DirecTV, XM Satellite Radio, along with friendly and attentive on-board service. Other amenities include its recently added Mint class, which is a luxury version of first-class travel. The Mint service features small private suites with a lie-flat bed up to 6 feet 8 inches long, a high-resolution personal screen, and free in-flight high-speed Wi-Fi ("Fly-Fi"). It also features other amenities such as personal check-in and early boarding, free bag checking

and priority bag retrieval after flight, and complimentary gourmet food and alcoholic beverages in flight.

For JetBlue, pursuing a blue ocean strategy by combining a cost-leadership position with a differentiation strategy resulted in a competitive advantage in its early years. Although the idea of combining different business strategies seems appealing, it is quite difficult to execute a cost-leadership and differentiation position at the same time. This is because cost leadership and differentiation are distinct strategic positions. Pursuing them simultaneously results in trade-offs that work against each other. For instance, higher perceived customer value (e.g., providing leather seats throughout the entire aircraft and free Wi-Fi) comes with higher costs. These trade-offs caught up with JetBlue. Between 2007 and 2015, the airline upstart faced severe turbulence after several high-profile mishaps (e.g., passengers stranded on the tarmac for hours after a snowstorm, emergency landings, erratic pilot and crew behaviors). These public relations disasters compounded the fundamental difficulty of resolving the need to limit costs while providing superior customer service and in-flight amenities.

This fundamental conflict was not apparent at first. In its early days, JetBlue could use value innovation to drive up perceived customer value even while lowering operating costs. The approach can work when an airline is small and connecting a few highly profitable city routes. But as the airline grew, its blue ocean strategy started to fray. As a consequence of such factors, JetBlue experienced a sustained competitive disadvantage for a number of years. The airline removed founder Neeleman as CEO in 2007. He left to found Azul, a Brazilian airline, in 2008. (In 2017 Azul was a publicly listed company on both the NYSE and the Sao Paulo exchanges with positive results; Azul is currently the third-largest airline in Brazil.)

Meanwhile, unable to overcome challenges in its profit and market share, the JetBlue board of directors in 2015 accepted the resignation of then CEO David Barger and appointed Robin Hayes to replace him. Formerly with British Airways for almost 20 years, Hayes wasted no time in sharpening JetBlue's strategic profile, doubling down on its blue ocean strategy as he attempted to lower operating costs while increasing perceived value creation. To drive down costs, he decided to add more seats to each plane, reducing legroom in coach (now on par with the legacy carriers). Other areas of cost savings included mainly aircraft maintenance and crew scheduling. At the same time, Hayes also expanded the Mint class offerings to many more flights, providing a product that customers love and that some other airlines lack.

JetBlue is also considering adding a new airplane (Airbus A-321) to its fleet, which scores significantly higher in customer satisfaction surveys than the older A-320. Although JetBlue already flies internationally by serving destinations in Central and South America as well as the Caribbean, Hayes is considering adding selected flights to Europe in the future. Flying non-stop to cities in Europe is now possible with new Airbus A-321. Flying longer, non-stop routes drives down costs. International routes, moreover, tend to be much more profitable than domestic routes because of less competition, for the time being.

JetBlue is now the sixth-largest airline in the United States, right after the "big four" (Delta, SWA, American, and United) and Alaska Airlines, which beat out JetBlue in acquiring Virgin America in 2016. Noteworthy is also that the "big four" airlines control more than 80 percent of the U.S. domestic market, so the industry is fairly concentrated.¹

You will learn more about JetBlue by reading this chapter; related questions appear in "ChapterCase 6 / Consider This . . ."



THE CHAPTERCASE illustrates how JetBlue ran into trouble by pursuing two different business strategies at the same time—a *cost-leadership* strategy, focused on low cost, and a *differentiation* strategy, focused on delivering unique features and service. Although the idea of combining different business strategies seems appealing, it is quite difficult to execute a cost-leadership and differentiation position at the same time. This is because cost leadership and differentiation are distinct strategic positions. Pursuing them simultaneously results in trade-offs that work against each other. For instance, higher perceived customer value (e.g., providing leather seats throughout the entire aircraft and free Wi-Fi) comes with higher costs.

Many firms that attempt to combine cost-leadership and differentiation strategies end up being *stuck in the middle*. In this situation, strategic leaders have failed to carve out a clear *strategic position*. In their attempt to be everything to everybody, these firms end up being neither a low-cost leader nor a differentiator (thus the phrase *stuck in the middle* between

the two distinct strategic positions). This common strategic failure contributed to JetBlue's sustained competitive disadvantage during the 2007 to 2015 time period. Strategic leaders need to be aware to not end up being *stuck in the middle* between distinct business strategies. A clear strategic position—either as differentiator or low-cost leader—is more likely to form the basis for competitive advantage. Although quite attractive at first glance, a *blue ocean strategy* is difficult to implement because of the trade-offs between the two distinct strategic positions (low-cost leadership and differentiation), unless the firm is successful in *value innovation* that allows a reconciliation of these inherent trade-offs (discussed in detail later).

This chapter, the first in Part 2 on strategy *formulation*, takes a close look at business-level strategy, frequently also referred to as *competitive strategy*. It deals with *how* to compete for advantage. Based on the analysis of the external and internal environments (presented in Part 1), the second step in the *AFI Strategy Framework* is to formulate a business strategy that enhances the firm's chances of achieving a competitive advantage.

We begin our discussion of strategy formulation by defining *business-level strategy*, *strategic position*, and *generic business strategies*. We then look at two key generic business strategies: *differentiation* and *cost leadership*. We pay special attention to value and cost drivers that managers can use to carve out a clear strategic profile. Next, we relate the two business-level strategies to the external environment, in particular, to the five forces, to highlight their respective benefits and risks. We then introduce the notion of *blue ocean strategy*—using *value innovation* to combine a differentiation and cost-leadership strategic position. We also look at changes in competitive positioning over time before concluding with practical *Implications for Strategic Leaders*.

6.1 Business-Level Strategy: How to Compete for Advantage

Business-level strategy details the goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.² It may involve a single product or a group of similar products that use the same distribution channel. It concerns the broad question, “How should we compete?” To formulate an appropriate business-level strategy, managers must answer the who, what, why, and how questions of competition:

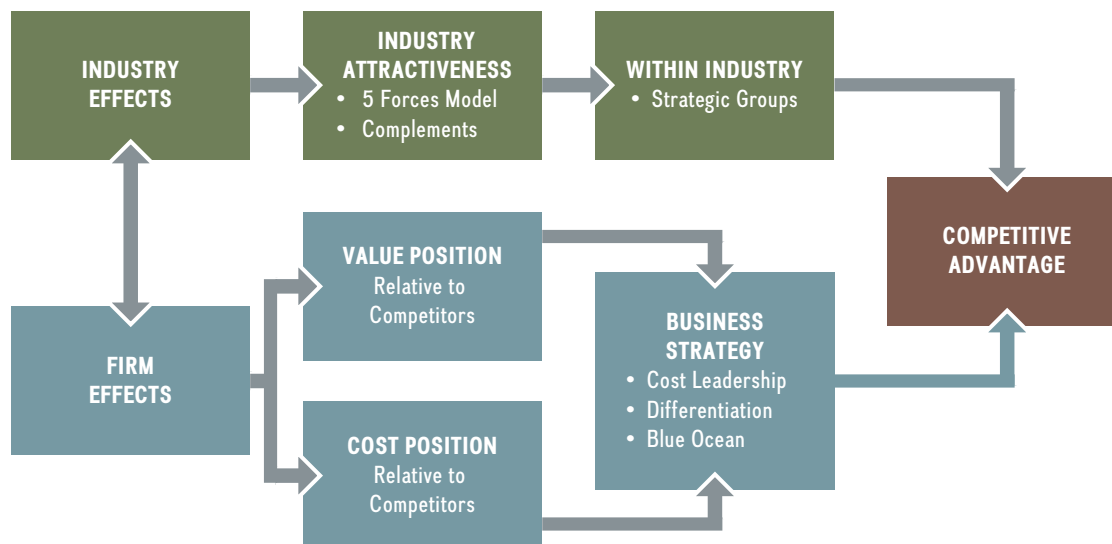
- *Who*—which customer segments will we serve?
- *What* customer needs, wishes, and desires will we satisfy?
- *Why* do we want to satisfy them?
- *How* will we satisfy our customers' needs?³

To formulate an effective business strategy, managers need to keep in mind that competitive advantage is determined jointly by *industry* and *firm* effects. As shown in Exhibit 6.1, one route to competitive advantage is shaped by *industry effects*, while a second route is determined by *firm effects*. As discussed in Chapter 3, an industry's profit potential can be assessed using the five forces framework plus the availability of complements. Managers need to be certain that the business strategy is aligned with the five forces that shape competition. They can evaluate performance differences among clusters of firms in the same industry by conducting a strategic-group analysis. The concepts introduced in Chapter 4 are key in understanding firm effects because they allow us to look inside firms and explain why they differ based on their resources, capabilities, and competencies. It is also important to note that industry and firm effects are not independent, but rather they are *interdependent*, as shown by the two-pointed arrow connecting industry effects and firm effects in Exhibit 6.1. At the firm level, performance is determined by value and cost positions *relative* to competitors. This is the firm's *strategic position*, to which we turn next.

LO 6-1

Define business-level strategy and describe how it determines a firm's strategic position.

business-level strategy The goal-directed actions managers take in their quest for competitive advantage when competing in a single product market.

EXHIBIT 6.1 / Industry and Firm Effects Jointly Determine Competitive Advantage**STRATEGIC POSITION**

We noted in Chapter 5 that competitive advantage is based on the difference between the *perceived value* a firm is able to create for consumers (V), captured by how much consumers are willing to pay for a product or service, and the total cost (C) the firm incurs to create that value. The greater the *economic value created* ($V - C$), the greater is a firm's potential for competitive advantage. To answer the business-level strategy question of how to compete, managers have two primary competitive levers at their disposal: value (V) and cost (C).

A firm's business-level strategy determines its *strategic position*—its strategic profile based on value creation and cost—in a specific product market. A firm attempts to stake out a valuable and unique position that meets customer needs while simultaneously creating as large a gap as possible between the value the firm's product creates and the cost required to produce it. Higher value creation tends to require higher cost. To achieve a desired strategic position, managers must make **strategic trade-offs**—choices between a cost *or* value position. Managers must address the tension between value creation and the pressure to keep cost in check so as not to erode the firm's economic value creation and profit margin. As shown in the ChapterCase, JetBlue experienced a competitive disadvantage for a number of years because it was unable to effectively address the strategic trade-offs inherent in pursuing a cost-leadership *and* differentiation strategy at the same time. A business strategy is more likely to lead to a competitive advantage if a firm has a clear strategic profile, either as differentiator *or* a low-cost leader. A *blue ocean strategy* is only successful, in contrast, if the firm can implement some type of value innovation that reconciles the inherent trade-off between value creation and underlying costs.

strategic trade-offs Choices between a cost *or* value position. Such choices are necessary because higher value creation tends to generate higher cost.

differentiation strategy Generic business strategy that seeks to create higher value for customers than the value that competitors create, while containing costs.

GENERIC BUSINESS STRATEGIES

There are two fundamentally different generic business strategies—*differentiation* and *cost leadership*. A **differentiation strategy** seeks to create higher value for customers than the value that competitors create, by delivering products or services with unique features while

keeping costs at the same or similar levels, allowing the firm to charge higher prices to its customers. A **cost-leadership strategy**, in contrast, seeks to create the same or similar value for customers by delivering products or services at a lower cost than competitors, enabling the firm to offer lower prices to its customers.

These two business strategies are called *generic strategies* because they can be used by any organization—manufacturing or service, large or small, for-profit or nonprofit, public or private, domestic or foreign—in the quest for competitive advantage, independent of industry context. Differentiation and cost leadership require distinct strategic positions, and in turn increase a firm’s chances to gain and sustain a competitive advantage.⁴ Because value creation and cost tend to be positively correlated, however, important trade-offs exist between value creation and low cost. A business strategy, therefore, is more likely to lead to a competitive advantage if it allows firms to either *perform similar activities differently* or *perform different activities* than their rivals that result in creating more value or offering similar products or services at lower cost.⁵

When considering different business strategies, managers also must define the **scope of competition**—whether to pursue a specific, narrow part of the market or go after the broader market.⁶ The automobile industry provides an example of the *scope of competition*. Alfred P. Sloan, longtime president and CEO of GM, defined the carmaker’s mission as providing a car for every purse and purpose. GM was one of the first to implement a multidivisional structure in order to separate the brands into strategic business units, allowing each brand to create its unique strategic position (with its own profit and loss responsibility) within the broad automotive market. For example, GM’s product lineup ranges from the low-cost-positioned Chevy brand to the differentiated Cadillac brand. In this case, Chevy is pursuing a broad cost-leadership strategy, while Cadillac is pursuing a broad differentiation strategy. The two different business strategies are integrated at the corporate level at GM (more on *corporate strategy* in Chapters 8 and 9). On the other hand, Tesla, the maker of all-electric cars (featured in ChapterCase 1), offers a highly differentiated product and pursues only a small market segment. At this point, it uses a *focused differentiation strategy*. In particular, Tesla focuses on environmentally conscious consumers who are willing to pay a premium price. Going forward, Tesla is hoping to broaden its competitive scope with its new Model 3, priced at roughly half of the existing models (Model S sedan and Model X sport utility crossover). Taken together, GM’s competitive scope is broad—with a focus on the mass automotive market—while Tesla’s competitive scope is narrow—with a focus on all-electric luxury cars.

Now we can combine the dimensions describing a firm’s strategic position (*differentiation versus cost*) with the scope of competition (*narrow versus broad*). As shown in Exhibit 6.2, by doing so we get the two major broad business strategies (*cost leadership* and *differentiation*), shown as the top two boxes in the matrix, and the *focused* version of each, shown as the bottom two boxes in the matrix. The focused versions of the two

cost-leadership strategy Generic business strategy that seeks to create the same or similar value for customers at a lower cost.

scope of competition The size—narrow or broad—of the market in which a firm chooses to compete.

EXHIBIT 6.2 / Strategic Position and Competitive Scope: Generic Business Strategies



SOURCE: Adapted from M.E. Porter (1980), *Competitive Strategy. Techniques for Analyzing Industries and Competitors* (New York: Free Press).

focused cost-leadership strategy Same as the cost-leadership strategy except with a narrow focus on a niche market.

focused differentiation strategy Same as the differentiation strategy except with a narrow focus on a niche market.

business strategies—**focused cost-leadership strategy** and **focused differentiation strategy**—are essentially the same as the broad generic strategies *except* that the competitive scope is narrower. For example, the manufacturing company BIC pursues a focused cost-leadership strategy, designing and producing disposable pens and cigarette lighters at a low cost, while Mont Blanc pursues a focused differentiation strategy, offering exquisite pens—what it calls “writing instruments”—frequently priced at several hundred dollars.

As discussed in ChapterCase 6, JetBlue attempts to combine a focused cost-leadership position with a focused differentiation position. Although initially successful, JetBlue has been consistently outperformed for several years by airlines that do not attempt to straddle different strategic positions, but rather have a clear strategic profile as either a differentiator or a low-cost leader. For example, Southwest Airlines competes clearly as a broad cost leader (and would be placed squarely in the upper-left quadrant of Exhibit 6.2). The legacy carriers—Delta, American, and United—all compete as broad differentiators (and would be placed in the upper-right quadrant of Exhibit 6.2). Regionally, we find smaller airlines that are ultra low cost, such as Allegiant Air, Frontier Airlines, or Spirit Airlines, with a very clear strategic position. These smaller airlines would be placed in the lower-left quadrant of Exhibit 6.2 because they are pursuing a focused cost-leadership strategy. Based on a clear strategic position, these airlines have outperformed JetBlue over many years. The reason is that JetBlue appears to be stuck between different strategic positions, trying to combine a focused cost-leadership position with focused differentiation. As JetBlue grew, the problems inherent in an attempt to straddle different strategic positions grew more severe because JetBlue now attempts to also straddle the (broad) cost-leadership position with the (broad) differentiation position, thus trying to be everything to everybody. Being *stuck in the middle* of different strategic positions is a recipe for inferior performance and competitive disadvantage—and this is exactly what JetBlue has experienced between 2007 and 2015. Over the past few years, JetBlue has performed roughly on par with the industry average, as determined by the Dow Jones Airlines Index, including the big four airlines (American, Delta, SWA, and United) as well as smaller airlines such as Alaska Airlines, Allegiant Air, and Spirit. Part of JetBlue’s ability to close its performance gap is the highly successful rollout of the Mint experience, which offers first-class travel at a discount. Indeed, on routes where JetBlue offers its Mint experience (such as flying coast to coast), the legacy airlines have dropped their first-class prices significantly to be competitive with JetBlue. Many customers, however, feel that the Mint travel experience is superior to first-class travel on traditional airlines.⁷

LO 6-2

Examine the relationship between value drivers and differentiation strategy.

6.2 Differentiation Strategy: Understanding Value Drivers

The goal of a differentiation strategy is to add unique features that will increase the perceived value of goods and services in the minds of consumers so they are willing to pay a higher price. Ideally, a firm following a differentiation strategy aims to achieve in the minds of consumers a level of value creation that its competitors cannot easily match. The focus of competition in a differentiation strategy tends to be on unique product features, service, and new-product launches, or on marketing and promotion rather than price.

Several competitors in the bottled-water industry provide a prime example of pursuing a successful differentiation strategy.⁸ As more and more consumers shift from carbonated soft drinks to healthier choices, the industry for bottled water is booming—growing

about 10 percent per year. In the United States, the per person consumption of bottled water surpassed that of carbonated soft drinks for the first time in 2016. Such a fast-growing industry provides ample opportunity for differentiation. In particular, the industry is split into two broad segments depending on the sales price. Bottled water with a sticker price of \$1.30 or less per 32 ounces (close to one liter) is considered low-end, while those with a higher price tag are seen as luxury items. For example, PepsiCo's Aquafina and Coca-Cola's Dasani are considered low-end products, selling purified tap water at low prices, often in bulk at big-box retailers such as Walmart. On the premium end, PepsiCo introduced Lifewtr with a splashy ad during Super Bowl LI in 2017, while Jennifer Aniston markets Smartwater, Coca-Cola's premium water.



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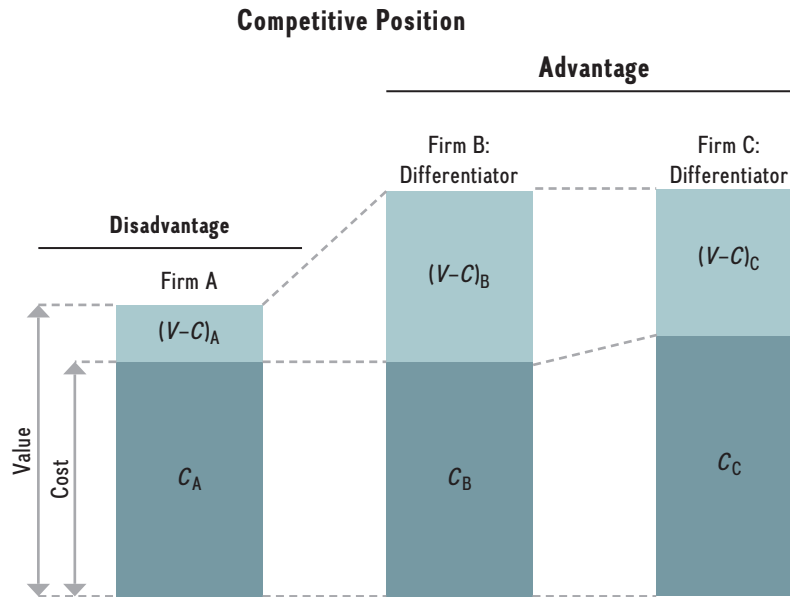
The idea of selling premium water is not new, however. Evian (owned by Danone, a French consumer products company) and Pellegrino (owned by Nestlé of Switzerland) have long focused on differentiating their products by emphasizing the uniqueness of their respective natural sources (Evian hails from the French Alps while Pellegrino comes from San Pellegrino Terme in Italy's Lombardy region). Recent entrants into the luxury segment for bottled water have taken the differentiation of their products to new heights. Some purveyors, such as Svalbardi, are able to charge super premium prices. At upscale retailer Harrods in London, a bottle of Svalbardi costs about \$100 for 25 ounces; the water, sold in a heavy glass bottle, hails from Norwegian icebergs some 4,000 years old. Ordering premium bottled water in the United States to accompany lunch has become a status symbol. Indeed, many restaurants now feature water lists besides the more traditional wine selection. "Energy waters" enhanced with minerals and vitamins are the fastest-growing segment. Although flavored waters make up less than 5 percent of the overall market for bottled water, they rack up 15 percent of total revenues. And this is nothing to be snuffed at: The market for bottled water globally reached some \$150 billion, and continues to grow fast. Although a free substitute can be had from most taps in industrialized countries, the success of many luxury brands in the bottled-water industry shows the power of differentiation strategy.

A company that uses a differentiation strategy can achieve a competitive advantage as long as its economic value created ($V - C$) is greater than that of its competitors. Firm A in Exhibit 6.3 produces a generic commodity. Firm B and Firm C represent two efforts at differentiation. Firm B not only offers greater value than Firm A, but also maintains *cost parity*, meaning it has the same costs as Firm A. However, even if a firm fails to achieve cost parity (which is often the case because higher value creation tends to go along with higher costs in terms of higher-quality raw materials, research and development, employee training to provide superior customer service, and so on), it can still gain a competitive advantage if its economic value creation exceeds that of its competitors. Firm C represents just such a competitive advantage. For the approach shown *either* in Firm B or Firm C, economic value creation, $(V - C)_B$ or $(V - C)_C$, is greater than that of Firm A $(V - C)_A$. Either Firm B or C, therefore, achieves a competitive advantage because it has a higher value gap over Firm A [$(V - C)_B > (V - C)_A$, or $(V - C)_C > (V - C)_A$], which allows it to charge a premium price, reflecting its higher value creation. To complete the relative

EXHIBIT 6.3 /

Differentiation Strategy: Achieving Competitive Advantage

Under a differentiation strategy, firms that successfully differentiate their products enjoy a competitive advantage. Firm A's product is seen as a generic commodity with no unique brand value. Firm B has the same cost structure as Firm A but creates more economic value, and thus has a competitive advantage over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$. Although, Firm C has higher costs than Firm A and B, it still generates a significantly higher economic value than Firm A.



comparison, although both companies pursue a differentiation strategy, Firm B also has a competitive advantage over Firm C because although both offer identical value, Firm B has lower cost, thus $(V - C)_B > (V - C)_C$.

Although increased value creation is a defining feature of a differentiation strategy, managers must also control costs. Rising costs reduce economic value created and erode profit margins. Indeed, if cost rises too much as the firm attempts to create more perceived value for customers, its value gap shrinks, negating any differentiation advantage. One reason JetBlue could not maintain an initial competitive advantage was because it was unable to keep its costs down sufficiently. JetBlue's new management team immediately put measures in place to lower the airline's cost structure such as charging fees for checked bags and reducing leg space to increase passenger capacity on each of its planes. These cost-saving initiatives should increase its economic value creation.

Although a differentiation strategy is generally associated with premium pricing, managers have an important second pricing option. When a firm is able to offer a differentiated product or service and can control its costs at the same time, it is able to gain market share from other firms in the industry by charging a similar price but offering more perceived value. By leveraging its differentiated appeal of superior customer service and quality, for example, Marriott offers a line of different hotels: its flagship Marriott full-service business hotel equipped to host large conferences; Residence Inn for extended stay; Marriott Courtyard for business travelers; and Marriott Fairfield Inn for inexpensive leisure and family travel.⁹ Although these hotels are roughly comparable to competitors in price, they generally offer a higher perceived value. With this line of different hotels, Marriott can benefit from economies of scale and scope, and thus keep its cost structure in check. *Economies of scale* denote decreases in cost per unit as output increases (more in the next section when we discuss cost-leadership strategy). **Economies of scope** describe the savings that come from producing two (or more) outputs at less cost than producing each output individually, even though using the same resources and technology. This larger difference between cost and value allows Marriott to achieve greater economic value than its competitors, and thus to gain market share and post superior performance.

economies of scope Savings that come from producing two (or more) outputs at less cost than producing each output individually, despite using the same resources and technology.

Managers can adjust a number of different levers to improve a firm's strategic position. These levers either increase perceived value or decrease costs. Here, we will study the most salient *value drivers* that managers have at their disposal (we look at cost drivers in the next section).¹⁰ They are:

- Product features
- Customer service
- Complements

These value drivers are related to a firm's expertise in, and organization of, different internal value chain activities. Although these are the most important value drivers, no such list can be complete. Applying the concepts introduced in this chapter should allow strategic leaders to identify other important value and cost drivers unique to their business.

When attempting to increase the perceived value of the firm's product or service offerings, managers must remember that the different value drivers contribute to competitive advantage *only if* their increase in value creation (ΔV) exceeds the increase in costs (ΔC). The condition of $\Delta V > \Delta C$ must be fulfilled if a differentiation strategy is to strengthen a firm's strategic position and thus enhance its competitive advantage.

PRODUCT FEATURES

One of the obvious but most important levers that strategic leaders can adjust is product features, thereby increasing the perceived value of the product or service offering. Adding unique product attributes allows firms to turn commodity products into differentiated products commanding a premium price. Strong R&D capabilities are often needed to create superior product features. In the kitchen-utensil industry, OXO follows a differentiation strategy, highlighting product features. By adhering to its philosophy of making products that are easy to use for the largest variety of possible users,¹¹ OXO differentiates its kitchen utensils through its patent-protected ergonomically designed soft black rubber grips.

CUSTOMER SERVICE

Managers can increase the perceived value of their firms' product or service offerings by focusing on customer service. For example, the online retailer Zappos earned a reputation for superior customer service by offering free shipping both ways: to the customer and for returns.¹² Zappos's strategic leaders didn't view this as an additional expense but rather as part of their marketing budget. Moreover, Zappos does not outsource its customer service, and its associates do not use predetermined scripts. They are instead encouraged to build a relationship of trust with each individual customer. There seemed to be a good return on investment as word spread through the online shopping community. Competitors took notice, too; Amazon bought Zappos for over \$1 billion.¹³

COMPLEMENTS

When studying industry analysis in Chapter 3, we identified the availability of complements as an important force determining the profit potential of an industry. Complements add value



Trader Joe's is a chain of more than 400 stores, half of which are in California and the rest in another 38 states plus Washington, D.C. The chain is known for good products, value for money, clerks in Hawaiian shirts—and great customer service. As just one example, stores happily stock local products as requested by their communities.¹⁴

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Photos/Alamy Stock Photo

to a product or service when they are consumed in tandem. Finding complements, therefore, is an important task for managers in their quest to enhance the value of their offerings.

A prime example of complements is smartphones and cellular services. A smartphone without a service plan is much less useful than one with a data plan. Traditionally, the providers of phones such as Apple, Samsung, and others did not provide wireless services. AT&T and Verizon are by far the two largest service providers in the United States, jointly holding some 70 percent of market share. To enhance the attractiveness of their phone and service bundles, phone makers and service providers frequently sign exclusive deals. When first released, for instance, service for the iPhone was exclusively offered by AT&T. Thus, if you wanted an iPhone, you had to sign up for a two-year service contract with AT&T.

Google, a division of Alphabet, decided to offer the important complements of smartphones and wireless services in-house to attract more customers.¹⁵ Google offers high-end phones such as the Pixel 2 with cutting-edge artificial intelligence built in (via its Google Assistant) at competitive prices. It combines this with discounted high-speed wireless services in its Project Fi, a complementary offering. Working in conjunction with smaller wireless service providers such as Sprint and T-Mobile, Google provides seamless wireless services by stitching together a nationwide network of services based on available free Wi-Fi hotspots (such as at Starbucks) and cellular networks offered by Sprint or T-Mobile. This not only enables wide coverage, but also reduces data usage significantly because Google phones automatically switch to free Wi-Fi networks wherever available.

Project Fi is intended to drive more demand for Google's phone; sales have been lackluster thus far. Stronger demand for Google's phones locks more users into the Google ecosystem as its wireless services are available only with its own phones. This provides an example where complementary product and service offerings not only reinforce demand for one another, but also create a situation where network externalities can arise. As more users sign up for Project Fi, Google is able to offer faster and more reliable services (through investing more into the latest technology, such as 5G), making its network and with it its Google phones more attractive to more users, and so forth.

As you have just seen, the differentiation strategy covers a great deal of ground, so let's summarize what we have learned. By choosing the differentiation strategy as the strategic position for a product, managers focus their attention on adding value to the product through its unique features that respond to customer preferences, customer service during and after the sale, or effective marketing that communicates the value of the product's features. Although this positioning involves increased costs (for example, higher-quality inputs or innovative research and development activities), customers will be willing to pay a premium price for the product or service that satisfies their needs and preferences. In the next section, we will discuss how managers formulate a cost-leadership strategy.

LO 6-3

Examine the relationship between cost drivers and cost-leadership strategy.

6.3 Cost-Leadership Strategy: Understanding Cost Drivers

The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors while offering adequate value. The *cost leader*, as the name implies, focuses its attention and resources on reducing the cost to manufacture a product or on lowering the operating cost to deliver a service in order to offer lower prices to its customers. The cost leader attempts to optimize all of its value chain activities to achieve a low-cost position. Although staking out the lowest-cost position in the industry is the overriding strategic objective, a cost leader still needs to offer products and services of acceptable value. As an example, GM and Korean car manufacturer Kia offer some models that compete directly with one another, yet Kia's cars tend to be produced at lower cost, while providing a similar value proposition.

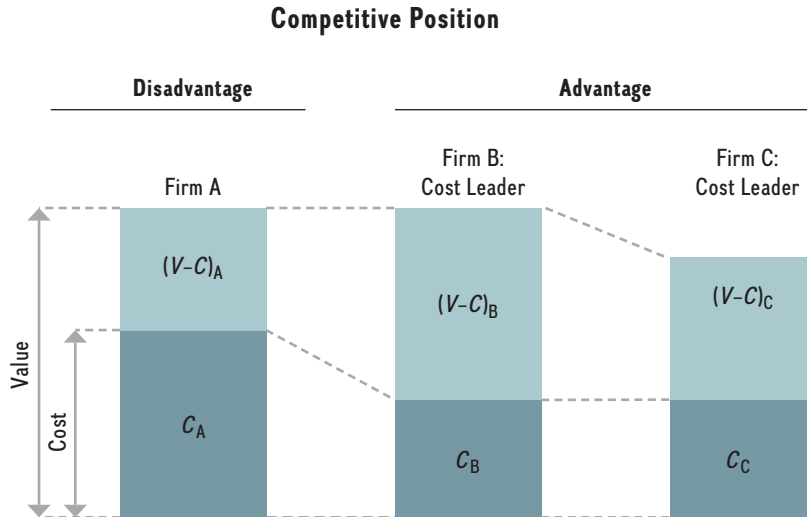


EXHIBIT 6.4 /

Cost-Leadership Strategy: Achieving Competitive Advantage

Under a cost-leadership strategy, firms that can keep their cost at the lowest point in the industry while offering acceptable value are able to gain a competitive advantage. Firm A has not managed to take advantage of possible cost savings, and thus experiences a competitive disadvantage. The offering from Firm B has the same perceived value as Firm A but through more effective cost containment creates more economic value (over both Firm A and Firm C because $(V - C)_B > (V - C)_C > (V - C)_A$). The offering from Firm C has a lower perceived value than that of Firm A or B and has the same reduced product cost as with Firm B; as a result, Firm C still generates higher economic value than Firm A.

A cost leader can achieve a competitive advantage as long as its economic value created ($V - C$) is greater than that of its competitors. Firm A in Exhibit 6.4 produces a product with a cost structure vulnerable to competition. Firms B and C show two different approaches to cost leadership. Firm B achieves a competitive advantage over Firm A because Firm B not only has lower cost than Firm A, but also achieves *differentiation parity* (meaning it creates the same value as Firm A). As a result, Firm B's economic value creation, $(V - C)_B$, is greater than that of Firm A, $(V - C)_A$. For example, as the low-cost leader, Walmart took market share from Kmart, which subsequently filed for bankruptcy.

What if a firm fails to create differentiation parity? Such parity is often hard to achieve because value creation tends to go along with higher costs, and Firm B's strategy is aimed at lower costs. A firm can still gain a competitive advantage as long as its economic value creation exceeds that of its competitors. Firm C represents this approach to cost leadership. Even with lower value (no differentiation parity) but lower cost, Firm C's economic value creation, $(V - C)_C$, still is greater than that of Firm A, $(V - C)_A$.

In both approaches to cost leadership in Exhibit 6.4, Firm B's economic value creation is greater than that of Firm A and Firm C. Yet, both firms B and C achieve a competitive advantage over Firm A. Either one can charge prices similar to its competitors and benefit from a greater profit margin per unit, or it can charge lower prices than its competition and gain higher profits from higher volume. Both variations of a cost-leadership strategy can result in competitive advantage. Although Firm B has a competitive advantage over both firms A and C, Firm C has a competitive advantage in comparison to Firm A.

Although companies successful at cost leadership must excel at controlling costs, this doesn't mean that they can neglect value creation. Kia signals the quality of its cars with a five-year, 60,000-mile warranty, one of the more generous warranties in the industry. Walmart offers products of acceptable quality, including many brand-name products.

The most important *cost drivers* that managers can manipulate to keep their costs low are:

- Cost of input factors.
- Economies of scale.
- Learning-curve effects.
- Experience-curve effects.

However, this list is only a starting point; managers may consider other cost drivers, depending on the situation.

COST OF INPUT FACTORS

One of the most basic advantages a firm can have over its rivals is access to lower-cost input factors such as raw materials, capital, labor, and IT services. In the market for international long-distance travel, the greatest competitive threat facing U.S. legacy carriers—American, Delta, and United—comes from three fast-growing airlines located in the Persian Gulf states—Emirates, Etihad, and Qatar. These airlines achieve a competitive advantage over their U.S. counterparts thanks to lower-cost inputs—raw materials (access to cheaper fuel), capital (interest-free government loans), labor—and fewer regulations (for example, regarding nighttime takeoffs and landings, or in adding new runways and building luxury airports with swimming pools, among other amenities).¹⁶ To benefit from lower-cost IT services, the Gulf carriers also outsource some value chain activities such as booking and online customer service to India. Together, these distinct cost advantages across several key input factors add up to create a greater economic value creation for the Gulf carriers vis-à-vis U.S. competitors, leading to a competitive advantage (more on the Gulf carriers in Strategy Highlight 10.1).

ECONOMIES OF SCALE

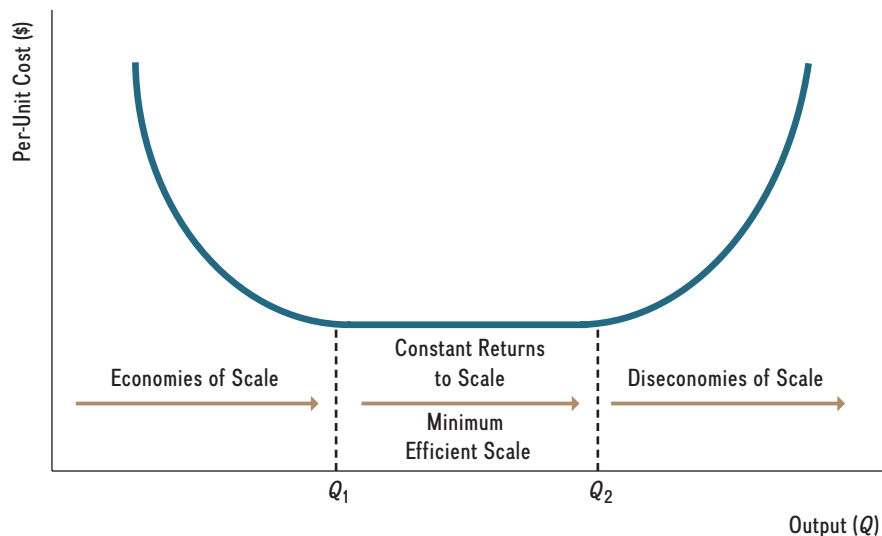
economies of scale Decreases in cost per unit as output increases.

Firms with greater market share might be in a position to reap **economies of scale**, decreases in cost per unit as output increases. This relationship between unit cost and output is depicted in the first (left-hand) part of Exhibit 6.5: Cost per unit falls as output increases up to point Q_1 . A firm whose output is closer to Q_1 has a cost advantage over other firms with less output. In this sense, bigger is better.

In the airframe-manufacturing industry, for example, reaping economies of scale and learning is critical for cost-competitiveness. The market for commercial airplanes is often not large enough to allow more than one competitor to reach sufficient scale to drive down unit cost. Boeing chose not to compete with Airbus in the market for superjumbo jets; rather, it decided to focus on a smaller, fuel-efficient airplane (the 787 Dreamliner, priced at roughly \$250 million) that allows for long-distance, point-to-point connections.

EXHIBIT 6.5 /

Economies of Scale, Minimum Efficient Scale, and Diseconomies of Scale



By 2017, it had built over 530 Dreamliners with more than 1,200 orders for the new airplane.¹⁷ Boeing can expect to reap significant economies of scale and learning, which will lower per-unit cost. At the same time, Airbus had delivered 210 A-380 superjumbos (sticker price: \$430 million) with more than 100 orders on its books.¹⁸ If both companies would have chosen to compete head-on in each market segment, the resulting per-unit cost for each airplane would have been much higher because neither could have achieved significant economies of scale (overall their market share split is roughly 50–50).

What causes per-unit cost to drop as output increases (up to point Q_1)? Economies of scale allow firms to:

- Spread their fixed costs over a larger output.
- Employ specialized systems and equipment.
- Take advantage of certain physical properties.

SPREADING FIXED COSTS OVER LARGER OUTPUT. Larger output allows firms to spread their fixed costs over more units. That is why gains in market share are often critical to drive down per-unit cost. This relationship is even more pronounced in many high-tech industries because most of the cost occurs before a single product or service is sold. Take operating systems software as an example. Microsoft spends over \$10 billion a year on research and development (R&D).¹⁹ Between 2011 and 2015, a good part of this was spent on developing Windows 10, its newest operating system software. This R&D expense was a fixed cost Microsoft had to incur before a single copy of Windows 10 was sold. However, once the initial version of the new software was completed, the marginal cost of each additional copy was basically zero, especially for copies sold in digital form online. Given that Microsoft dominates the operating system market for personal computers (PCs) with more than 90 percent market share, it expects to sell several hundred million copies of Windows 10, thereby spreading its huge fixed cost of development over a large output. Microsoft's huge installed base of Windows operating systems throughout the world allowed it to capture a large profit margin for each copy of Windows sold, after recouping its initial investment. Microsoft has high hopes for its newest operating system with the goal of bringing together not only PCs and mobile devices but also the Xbox One and other Windows devices. Microsoft's Windows 10 also drives sales for complementary products such as the ubiquitous Microsoft Office Suite made up of Word, Excel, PowerPoint, and Outlook, among other programs (as discussed in ChapterCase 5).

EMPLOYING SPECIALIZED SYSTEMS AND EQUIPMENT. Larger output also allows firms to invest in more specialized systems and equipment, such as enterprise resource planning (ERP) software or manufacturing robots. Tesla's strong demand for its new Model 3 sedan allows it to employ cutting-edge robotics in its Fremont, California, manufacturing plant to produce cars of the highest quality at large scale, and thus driving down costs.

TAKING ADVANTAGE OF CERTAIN PHYSICAL PROPERTIES. Economies of scale also occur because of certain physical properties. One such property is known as the *cube-square rule*: The volume of a body such as a pipe or a tank increases disproportionately more than its surface. This same principle makes big-box retail stores such as Walmart or The Home Depot cheaper to build and run. They can also stock much more merchandise and handle inventory more efficiently. Their huge size makes it difficult for department stores or small retailers to compete on cost and selection.

Look again at Exhibit 6.5. The output range between Q_1 and Q_2 in the figure is considered the **minimum efficient scale (MES)** to be cost-competitive. Between Q_1 and Q_2 , the returns to scale are constant. It is the output range needed to bring the cost per unit down as

minimum efficient scale (MES) Output range needed to bring down the cost per unit as much as possible, allowing a firm to stake out the lowest-cost position that is achievable through economies of scale.

much as possible, allowing a firm to stake out the lowest-cost position achievable through economies of scale. With more than 10 million Prius cars sold since its introduction in 1997, Toyota has been able to reach the minimum efficient scale part of the per-unit cost curve. This allows the company to offer the car at a relatively low price and still make a profit.

The concept of minimum efficient scale applies not only to manufacturing processes but also to managerial tasks such as how to organize work. Due to investments in specialized technology and equipment (e.g., electric arc furnaces), Nucor is able to reach MES with much smaller batches of steel than larger, fully vertically integrated steel companies using older technology. Nucor's optimal plant size is about 500 people, which is much smaller than at larger integrated steelmakers such as U.S. Steel which often employ thousands of workers per plant.²⁰ Of course, minimum efficient scale depends on the specific industry: The average per-unit cost curve, depicted conceptually in Exhibit 6.5, is a reflection of the underlying production function, which is determined by technology and other input factors.

Benefits to scale cannot go on indefinitely, though. Bigger is not always better; in fact, sometimes bigger is worse. Beyond Q_2 in Exhibit 6.5, firms experience **diseconomies of scale**—increases in cost as output increases. As firms get too big, the complexity of managing and coordinating the production process raises the cost, negating any benefits to scale. Large firms also tend to become overly bureaucratic, with too many layers of hierarchy. They grow inflexible and slow in decision making. To avoid problems associated with diseconomies of scale, Gore Associates, maker of GORE-TEX fabric, Glide dental floss, and many other innovative products, breaks up its company into smaller units. Gore Associates found that employing about 150 people per plant allows it to avoid diseconomies of scale. It uses a simple decision rule:²¹ “We put 150 parking spaces in the lot, and when people start parking on the grass, we know it’s time to build a new plant.”²²

Finally, there are also physical limits to scale. Airbus is pushing the envelope with its A-380 aircraft, which can hold more than 850 passengers and fly up to 8,200 miles (enough to travel nonstop from Boston to Hong Kong at about 600 mph). The goal, of course, is to drive down the cost of the average seat-mile flown (CASM, a standard cost metric in the airline industry). It remains to be seen whether the A-380 superjumbo will enable airlines to reach minimum efficient scale or will simply be too large to be efficient. For example, boarding and embarking procedures must be streamlined to accommodate more than 850 people in a timely and safe manner. Many airports around the world need to be retrofitted with longer and wider runways to allow the superjumbo to take off and land.

Scale economies are critical to driving down a firm's cost and strengthening a cost-leadership position. Although managers need to increase output to operate at a minimum efficient scale (between Q_1 and Q_2 in Exhibit 6.5), they also need to be watchful not to drive scale beyond Q_2 , where they would encounter diseconomies. In sum, if the firm's output range is less than Q_1 or more than Q_2 , the firm is at a cost disadvantage; reaching an output level between Q_1 and Q_2 is optimal in regards to driving down costs. Monitoring the firm's cost structure closely over different output ranges allows managers to fine-tune operations and benefit from economies of scale.

LEARNING CURVE

Do learning curves go up or down? Looking at the challenge of learning, many people tend to see it as an uphill battle, and assume the learning curve goes up. But if we consider our productivity, learning curves go down, as it takes less and less time to produce the same output as we learn how to be more efficient—learning by doing drives down cost. As individuals and teams engage repeatedly in an activity, whether writing computer code, developing new medicines, or building submarines, they learn from their cumulative

diseconomies of scale Increases in cost per unit when output increases.

experience.²³ *Learning curves* were first documented in aircraft manufacturing as the United States ramped up production in the 1930s, before its entry into World War II.²⁴ Every time production was doubled, the per-unit cost dropped by a predictable and constant rate (approximately 20 percent).²⁵

It is not surprising that a learning curve was first observed in aircraft manufacturing. Highly complex, a modern commercial aircraft can contain more than 5 million parts, compared with a few thousand for a car. The more complex the underlying process to manufacture a product or deliver a service, the more learning effects we can expect. As cumulative output increases, managers learn how to optimize the process, and workers improve their performance through repetition.

TESLA'S LEARNING CURVE. Tesla's production of its Model S vehicle provides a more recent example, depicted in Exhibit 6.6, with the horizontal axis showing cumulative output in units and the vertical axis showing per-unit cost in thousands of dollars.²⁶

The California-based designer and manufacturer of all-electric cars made headlines in 2017 when its market capitalization overtook both GM and Ford. This was the first time in U.S. history that the most valuable U.S. car company is not based in Detroit, Michigan, but in Silicon Valley. In 2016, Tesla sold some 80,000 vehicles, while GM sold some 10 million. How can a start-up company that makes less than 1 percent as many vehicles as GM have a higher market valuation? The answer: Future expected growth. Investors bidding up Tesla's share price count on the maker of all-electric cars to sell millions of its new Model 3. When the Model 3 was announced in 2016, Tesla garnered some 400,000 preorders from future owners for a car that was not yet produced, let alone test-driven by any potential buyer.

Tesla's learning curve is critical in justifying such lofty stock market valuations, because as production volume increases, production cost per car falls, and the company becomes profitable. Based on a careful analysis of production reports for the Model S between 2012 and 2014²⁷, Exhibit 6.6 shows how Tesla was able to drive down the unit cost for each car as production volume ramped up. Initially, Tesla lost a significant amount of money on each Model S sold because of high upfront R&D spending to develop the futuristic

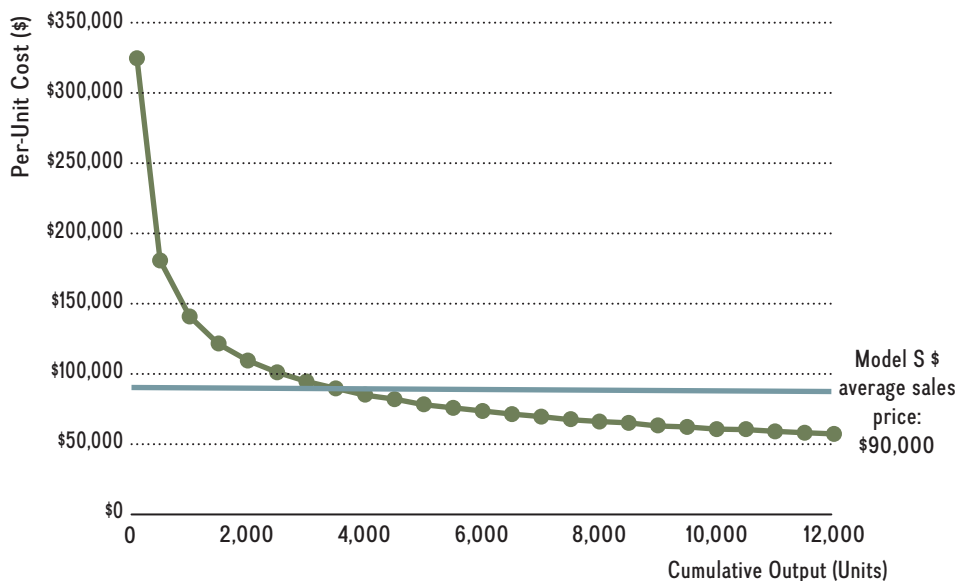


EXHIBIT 6.6 /
Tesla's Learning Curve
Producing the Model S

SOURCE: Depiction of functional relationship estimated in J. Dyer and H. Gregersen (2016), "Tesla's innovations are transforming the auto industry," *Forbes*, August 24.

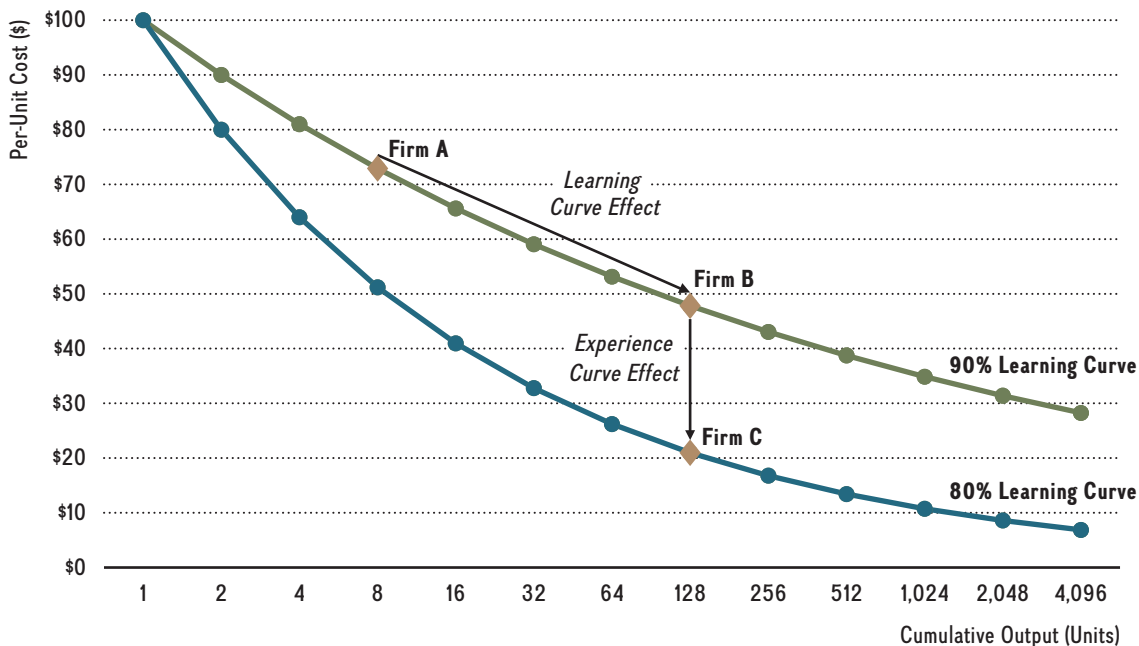
self-driving car. When producing only 1,000 vehicles, unit cost was \$140,000. As production volume of the Model S reached some 12,000 units per year (in 2014), unit cost fell to about \$57,000. Although still high, Tesla was able start making money on each car, because the average selling price for a Model S was about \$90,000.

The relationship between production volume and per-unit cost for Tesla (depicted in Exhibit 6.6) suggests that it is an 80 percent learning curve. In an 80 percent learning curve, per-unit cost drops 20 percent every time output is doubled. Assuming a similar relationship holds for the Model 3 production, then per-unit cost would fall to \$16,000 per Model 3 with a cumulative production volume of 400,000 (which is the number of preorders Tesla received within one week of announcing this new vehicle). Although the Model 3 base price is pegged at \$35,000, the estimated average selling price is more like \$50,000 given additional features and eventual expiration of a \$7,500 federal tax credit for electric vehicles (when a manufacturer hits 200,000 units). Riding down an 80 percent learning curve, Tesla could make a profit of an estimated \$34,000 per Model 3. This would translate to a cumulative profit for Tesla of more than \$13.5 billion for the Model 3 preorders alone. This back-of-the-envelope calculation shows some of the rationale behind Tesla's market capitalization exceeding that of GM and Ford.

Taken together, this example highlights not only the power of the learning curve in driving down per-unit costs, but also how critical cost containment is in gaining a competitive advantage when pursuing a differentiation strategy as Tesla does.

DIFFERENCES IN LEARNING CURVES. Let's now compare different learning curves, and explore their implications for competitive advantage. The steeper the learning curve, the more learning has occurred. As cumulative output increases, firms move down the learning curve, reaching lower per-unit costs. Exhibit 6.7 depicts two different learning curves: a 90 percent and an 80 percent learning curve. In a 90 percent learning curve, per-unit cost drops 10 percent every time output is doubled. The steeper 80 percent learning curve

EXHIBIT 6.7 / Gaining Competitive Advantage through Leveraging Learning- and Experience-Curve Effects



indicates a 20 percent drop every time output is doubled (this was the case in the Tesla example above). It is important to note that the learning-curve effect is driven by increasing cumulative output within the existing technology over time. That implies that the only difference between two points on the same learning curve is the size of the cumulative output. The underlying technology remains the same. The speed of learning determines the slope of the learning curve, or how steep the learning curve is (e.g., 80 percent is steeper than a 90 percent learning curve because costs decrease by 20 percent versus a mere 10 percent each time output doubles). In this perspective, *economies of learning* allow movement down a *given* learning curve based on current production technology.

By moving further down a given learning curve than competitors, a firm can gain a competitive advantage. Exhibit 6.7 shows that Firm B is further down the 90 percent learning curve than Firm A. Firm B leverages *economies of learning* due to larger cumulative output to gain an advantage over Firm A. The only variable that has changed is cumulative output; the technology underlying the 90 percent learning curve remained the same.

Let's continue with the example of manufacturing airframes. To be more precise, as shown in Exhibit 6.7, Firm A produces eight aircraft and reaches a per-unit cost of \$73 million per aircraft.²⁸ Firm B produces 128 aircraft using the same technology as Firm A (because both firms are on the same [90 percent] learning curve), but given a much larger cumulative output, its per unit-cost falls to only \$48 million. Thus, Firm B has a clear competitive advantage over Firm A, assuming similar or identical quality in output. We will discuss Firm C when we formally introduce the impact of changes in technology and process innovation.

Learning curves are a robust phenomenon observed in many industries, not only in manufacturing processes but also in alliance management, franchising, and health care.²⁹ For example, physicians who perform only a small number of cardiac surgeries per year can have a patient mortality rate five times higher than physicians who perform the same surgery more frequently.³⁰ Strategy Highlight 6.1 features Dr. Devi Shetty of India who reaped huge benefits by applying learning-curve principles to open-heart surgery, driving down cost while improving quality at the same time!

Learning effects differ from economies of scale (discussed earlier) as shown:

- **Differences in timing.** Learning effects occur *over time* as output accumulates, while economies of scale are captured at *one point in time* when output increases. The improvements in Tesla's production costs, featured earlier, resulted from some 12,000 units in cumulative output, but it took two years to reach this volume (see Exhibit 6.6). Although learning can decline or flatten (see Exhibit 6.7), there are no *diseconomies to learning* (unlike *diseconomies to scale* in Exhibit 6.5).
- **Differences in complexity.** In some production processes (e.g., the manufacture of steel rods), effects from economies of scale can be quite significant, while learning effects are minimal. In contrast, in some professions (brain surgery or the practice of estate law), learning effects can be substantial, while economies of scale are minimal.

Managers need to understand such differences to calibrate their business-level strategy. If a firm's cost advantage is due to economies of scale, a manager should worry less about employee turnover (and a potential loss in learning) and more about drops in production runs. In contrast, if the firm's low-cost position is based on complex learning, a manager should be much more concerned if a key employee (e.g., a star engineer) was to leave.

EXPERIENCE CURVE

In the *learning curve* just discussed, we assumed the underlying technology remained constant, while only cumulative output increased. In the *experience curve*, in contrast, we now change the underlying technology while holding cumulative output constant.³¹

Strategy Highlight 6.1

Dr. Shetty: “The Henry Ford of Heart Surgery”



©Namas Bhojani

Open-heart surgeries are complex medical procedures and loaded with risk. While well-trained surgeons using high-tech equipment are able to reduce mortality rates, costs for cardiac surgeries in the United States have climbed. Difficult heart surgeries can cost \$100,000 or more. A heart surgeon in India has driven the costs down to an average of \$2,000 per heart surgery, while delivering equal or better outcomes in terms of quality.

Dr. Devi Shetty's goal is to be “the Henry Ford of heart surgery.” Just like the great American industrialist who applied the learning curve to drive down the cost of an automobile to make it affordable, so Dr. Shetty is reducing the costs of health care and making some of the most complex medical procedures affordable to the world's poorest. A native of Mangalore, India, Dr. Shetty was trained as a heart surgeon at Guy's Hospital in London, one of Europe's best medical facilities. He first came to fame in the 1990s when he successfully conducted an open-heart bypass surgery on Mother Teresa, after she suffered a heart attack.

Dr. Shetty believes that the key to driving down costs in health care is not product innovation, but process innovation. He is able to drive down the cost of complex medical procedures from \$100,000 to \$2,000 not by doing one big thing, but rather by focusing on doing a thousand small things. Dr. Shetty is applying the concept of the learning curve to make a complex procedure routine and comparatively inexpensive. Part of the Narayana Health group, Dr. Shetty's hospital in Bangalore, India, performs so many cardiac procedures per year that doctors are able to get a great deal of experience quickly, which allows them to specialize in one or two complex procedures. The Narayana surgeons perform two or three procedures a day for six days a week, compared to U.S. surgeons who perform one or two procedures a day for five

days a week. The difference adds up. Some of Dr. Shetty's surgeons perform more specialized procedures by the time they are in their 30s than their U.S. counterparts will perform throughout their entire careers. This volume of experience allows the cardiac surgeons to move down the learning curve quickly, because the more heart surgeries they perform, the more their skills improve. With this skill level, surgical teams develop robust standard operating procedures and processes, where team members become experts at their specific tasks.

This expertise improves outcomes while the learning-curve effects of performing the same procedures over time also save money (see Exhibit 6.7). Other factors provide additional cost savings. At the same time, Dr. Shetty pays his cardiac surgeons the going rate in India, between \$110,000 and \$250,000 a year, depending on experience. Their U.S. counterparts earn two to three times the average Indian salary.

Dr. Shetty's health group also reduces costs through economies of scale. By performing thousands of heart surgeries a year, high fixed costs such as the purchase of expensive medical equipment can be spread over a much larger volume. The Narayana hospital in Bangalore has 1,000 beds (many times larger than the average U.S. hospital with 160 beds) and some 20 operating rooms that stay busy pretty much around the clock. This scale allows the Narayana heart clinic to cost-effectively employ specialized high-tech equipment. Given the large size of Dr. Shetty's hospital, he also has significant buying power, driving down the costs of the latest high-tech equipment from top-notch vendors such as GE. Wherever possible, Dr. Shetty sources lower-cost inputs such as sutures locally, rather than from the more expensive companies such as Johnson & Johnson. Further, the Narayana heart clinic shares common services, such as laboratories and blood bank and more mundane services such as catering, with the 1,400-bed cancer clinic next door. Taken together, all of these small changes result in significant cost savings, and so create a reinforcing system of low-cost value chain activities.

While many worry that high volume compromises quality, the data suggest the opposite: Narayana Health's medical outcomes in terms of mortality rate are equal to or even lower than the best hospitals in the United States. The American College of Cardiology frequently sends surgeons and administrators to visit the Narayana heart clinic. The college concluded that the clinic provides high-tech and high-quality care at low cost. Dr. Shetty now brings top-notch care at low cost to the masses in India. Narayana Health runs a chain of over 30 hospitals in 20 locations throughout India and performs some 100,000 heart surgeries a year.³²

In general, technology and production processes do not stay constant. *Process innovation*—a new method or technology to produce an existing product—may initiate a new and steeper curve. Assume that Firm C, on the same learning curve as Firm B, implements a new production process (such as lean manufacturing). In doing so, Firm C initiates an entirely new and steeper learning curve. Exhibit 6.7 shows this *experience-curve effect* based on a process innovation. Firm C jumps down to the 80 percent learning curve, reflecting the new and lower-cost production process. Although Firm B and Firm C produce the same cumulative output (each making 128 aircraft), the per-unit cost differs. Firm B's per-unit cost for each airplane, being positioned on the less-steep 90 percent learning curve is \$48 million.³³ In contrast, Firm C's per-unit cost, being positioned on the steeper 80 percent learning curve because of process innovation, is only \$21 million per aircraft, and thus less than half of that of Firm B. Clearly, Firm C has a competitive advantage over Firm B based on lower cost per unit (assuming similar quality).

Learning by doing allows a firm to lower its per-unit costs by moving down a given learning curve, while experience-curve effects based on process innovation allow a firm to leapfrog to a steeper learning curve, thereby driving down its per-unit costs.

In Strategy Highlight 6.1, we saw how Dr. Shetty leveraged learning-curve effects to save lives while driving down costs. One could argue that his Narayana Health group not only moved down a given learning curve using best industry practice, but it also jumped down to a new and steeper learning curve through process innovation. Dr. Shetty sums up his business strategy based on cost leadership: “Japanese companies reinvented the process of making cars (by introducing lean manufacturing). That’s what we’re doing in health care. What health care needs is process innovation, not product innovation.”³⁴

In a cost-leadership strategy, managers must focus on lowering the costs of production while maintaining a level of quality acceptable to the customer. If firms can share the benefits of lower costs with consumers, cost leaders appeal to the bargain-conscious buyer, whose main criterion is price. By looking to reduce costs in each value chain activity, managers aim for the lowest-cost position in the industry. They strive to offer lower prices than competitors and thus to increase sales. Cost leaders such as Walmart (“Every Day Low Prices”) can profit from this strategic position over time.

6.4 Business-Level Strategy and the Five Forces: Benefits and Risks

The business-level strategies introduced in this chapter allow firms to carve out strong strategic positions that enhance the likelihood of gaining and sustaining competitive advantage. The five forces model introduced in Chapter 3 helps managers assess the forces—threat of entry, power of suppliers, power of buyers, threat of substitutes, and rivalry among existing competitors—that make some industries more attractive than others. With this understanding of industry dynamics, managers use one of the generic business-level strategies to protect themselves against the forces that drive down profitability.³⁵ Exhibit 6.8 details the relationship between competitive positioning and the five forces. In particular, it highlights the benefits and risks of differentiation and cost-leadership business strategies, which we discuss next.

LO 6-4

Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

DIFFERENTIATION STRATEGY: BENEFITS AND RISKS

A differentiation strategy is defined by establishing a strategic position that creates higher perceived value while controlling costs. The successful differentiator stakes out a unique strategic position, where it can benefit from imperfect competition (as discussed in Chapter 3) and command a premium price. A well-executed differentiation strategy reduces rivalry among competitors.

EXHIBIT 6.8 / Competitive Positioning and the Five Forces: Benefits and Risks of Differentiation and Cost-Leadership Business Strategies

Competitive Force	Differentiation		Cost Leadership	
	Benefits	Risks	Benefits	Risks
Threat of entry	Protection against entry due to intangible resources such as a reputation for innovation, quality, or customer service	- Erosion of margins - Replacement	Protection against entry due to economies of scale	- Erosion of margins - Replacement
Power of suppliers	Protection against increase in input prices, which can be passed on to customers	Erosion of margins	Protection against increase in input prices, which can be absorbed	Erosion of margins
Power of buyers	Protection against decrease in sales prices, because well-differentiated products or services are not perfect imitations	Erosion of margins	Protection against decrease in sales prices, which can be absorbed	Erosion of margins
Threat of substitutes	Protection against substitute products due to differential appeal	Replacement, especially when faced with innovation	Protection against substitute products through further lowering of prices	Replacement, especially when faced with innovation
Rivalry among existing competitors	Protection against competitors if product or service has enough differential appeal to command premium price	- Focus of competition shifts to price - Increasing differentiation of product features that do not create value but raise costs - Increasing differentiation to raise costs above acceptable threshold	Protection against price wars because lowest-cost firm will win	- Focus of competition shifts to non-price attributes - Lowering costs to drive value creation below acceptable threshold

SOURCES: Based on M.E. Porter (2008), "The Five Competitive Forces That Shape Strategy," *Harvard Business Review*, January; and M.E. Porter (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

A successful differentiation strategy is likely to be based on unique or specialized features of the product, on an effective marketing campaign, or on intangible resources such as a reputation for innovation, quality, and customer service. A rival would need to improve the product features as well as build a similar or more effective reputation in order to gain market share. The threat of entry is reduced: Competitors will find such intangible advantages time-consuming and costly, and maybe impossible, to imitate. If the source of the differential appeal is intangible rather than tangible (e.g., reputation rather than observable product and service features), a differentiator is even more likely to sustain its advantage.

Moreover, if the differentiator is able to create a significant difference between perceived value and current market prices, the differentiator will not be so threatened by

increases in input prices due to powerful suppliers. Although an increase in input factors could erode margins, a differentiator is likely able to pass on price increases to its customers as long as its value creation exceeds the price charged. Since a successful differentiator creates perceived value in the minds of consumers and builds customer loyalty, powerful buyers demanding price decreases are unlikely to emerge. A strong differentiated position also reduces the threat of substitutes, because the unique features of the product have been created to appeal to customer preferences, keeping them loyal to the product. By providing superior quality beverages and other food items combined with a great customer experience and a global presence, Starbucks has built a strong differentiated appeal. It has cultivated a loyal following of customers who reward it with repeat business.

The viability of a differentiation strategy is severely undermined when the focus of competition shifts to price rather than value-creating features. This can happen when differentiated products become commoditized and an acceptable standard of quality has emerged across rival firms. Although the iPhone was a highly differentiated product when introduced in 2007, touch-based screens and other once-innovative features are now standard in smartphones. Indeed, Android-based smartphones hold some 82 percent market share, while Apple's iOS phones hold about 18 percent.³⁶ Several companies including Google; Samsung and LG, both of South Korea; and low-cost leader Huawei of China are attempting to challenge Apple's ability to extract significant profits from the smartphone industry based on its iPhone franchise. A differentiator also needs to be careful not to overshoot its differentiated appeal by adding product features that raise costs but not perceived value in the minds of consumers. For example, any additional increase in screen resolution beyond Apple's retina display cannot be detected by the human eye at a normal viewing distance. Finally, a differentiator needs to be vigilant that its costs of providing uniqueness do not rise above the customer's willingness to pay.

COST-LEADERSHIP STRATEGY: BENEFITS AND RISKS

A cost-leadership strategy is defined by obtaining the lowest-cost position in the industry while offering acceptable value. The cost leader, therefore, is protected from other competitors because of having the lowest cost. If a price war ensues, the low-cost leader will be the last firm standing; all other firms will be driven out as margins evaporate. Since reaping economies of scale is critical to reaching a low-cost position, the cost leader is likely to have a large market share, which in turn reduces the threat of entry.

A cost leader is also fairly well isolated from threats of powerful suppliers to increase input prices, because it is more able to absorb price increases through accepting lower profit margins. Likewise, a cost leader can absorb price reductions more easily when demanded by powerful buyers. Should substitutes emerge, the low-cost leader can try to fend them off by further lowering its prices to reinstall relative value with the substitute. For example, Walmart tends to be fairly isolated from these threats. Walmart's cost structure combined with its large volume allows it to work with suppliers in keeping prices low, to the extent that suppliers are often the party that experiences a profit-margin squeeze.

Although a cost-leadership strategy provides some protection against the five forces, it also carries some risks. If a new entrant with new and relevant expertise enters the market, the low-cost leader's margins may erode due to loss in market share while it attempts to learn new capabilities. For example, Walmart faces challenges to its cost leadership. Dollar General stores, and other smaller low-cost retail chains, have drawn customers who prefer a smaller format than the big box of Walmart. The risk of replacement is particularly pertinent if a potent substitute emerges due to an innovation. Leveraging ecommerce, Amazon has become a potent substitute and thus a powerful threat to many brick-and-mortar retail outlets including Barnes & Noble, Best Buy, The Home Depot, and even Walmart. Powerful

suppliers and buyers may be able to reduce margins so much that the low-cost leader could have difficulty covering the cost of capital and lose the potential for a competitive advantage.

The low-cost leader also needs to stay vigilant to keep its cost the lowest in the industry. Over time, competitors can beat the cost leader by implementing the same business strategy, but more effectively. Although keeping its cost the lowest in the industry is imperative, the cost leader must not forget that it needs to create an acceptable level of value. If continuously lowering costs leads to a value proposition that falls below an acceptable threshold, the low-cost leader's market share will evaporate. Finally, the low-cost leader faces significant difficulties when the focus of competition shifts from price to non-price attributes.

We have seen how useful the five forces model can be in industry analysis. None of the business-level strategies depicted in Exhibit 6.2 (cost leadership, differentiation, and focused variations thereof) is inherently superior. The success of each depends on context and relies on two factors:

- How well the strategy leverages the firm's internal strengths while mitigating its weaknesses.
- How well it helps the firm exploit external opportunities while avoiding external threats.

There is no single correct business strategy for a specific industry. The deciding factor is that the chosen business strategy provides a strong position that attempts to maximize economic value creation and is effectively implemented.

blue ocean strategy Business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs.

6.5 Blue Ocean Strategy: Combining Differentiation and Cost Leadership

So far we've seen that firms can create more economic value and the likelihood of gaining and sustaining competitive advantage in one of two ways—either increasing perceived consumer value (while containing costs) or lowering costs (while offering acceptable value).

Should managers try to do both at the same time? To accomplish this, they would need to integrate two different strategic positions: differentiation *and* low cost.³⁷ In general the answer is *no*. Managers should not pursue this complex strategy because of the inherent trade-offs in different strategic positions, unless they are able to reconcile the conflicting requirements of each generic strategy.

To meet this challenge, the strategy scholars Kim and Mauborgne advance the notion of a **blue ocean strategy**, which is a business-level strategy that successfully combines differentiation and cost-leadership activities using value innovation to reconcile the inherent trade-offs in those two distinct strategic

positions.³⁸ They use the metaphor of an ocean to denote market spaces. *Blue oceans* represent untapped market space, the creation of additional demand, and the resulting opportunities for highly profitable growth. In contrast, *red oceans* are the known market space of existing industries. In *red oceans* the rivalry among existing firms is cut-throat because the market space is crowded and competition is a zero-sum game. Products become commodities, and competition is focused mainly on price. Any market share gain comes at the expense of other competitors in the same industry, turning the oceans bloody red.

A blue ocean strategy allows a firm to offer a differentiated product or service at low cost. As one example of a blue ocean strategy, consider Trader Joe's, the grocer introduced



Canny managers may use *value innovation* to move to blue oceans, that is, to new and uncontested market spaces. Shown here is the famous "blue hole" just off Belize.

©Mlenny/Getty Images RF

earlier in the chapter. Trader Joe's had (prior to its 2017 acquisition by Amazon) much lower costs than Whole Foods for the same market of patrons desiring high value and health-conscious foods, and the chain scores exceptionally well in customer service and other areas. When a blue ocean strategy is successfully formulated and implemented, investments in differentiation and low cost are not substitutes but are complements, providing important positive spill-over effects. A successfully implemented blue ocean strategy allows firms two pricing options: First, the firm can charge a higher price than the cost leader, reflecting its higher value creation and thus generating greater profit margins. Second, the firm can lower its price below that of the differentiator because of its lower-cost structure. If the firm offers lower prices than the differentiator, it can gain market share and make up the loss in margin through increased sales.

VALUE INNOVATION

For a blue ocean strategy to succeed, managers must resolve trade-offs between the two generic strategic positions—low cost and differentiation.³⁹ This is done through **value innovation**, aligning innovation with total perceived consumer benefits, price, and cost (also see the discussion in Chapter 5 on *economic value creation*). Instead of attempting to out-compete your rivals by offering better features or lower costs, successful value innovation makes competition irrelevant by providing a leap in value creation, thereby opening new and uncontested market spaces.

Successful value innovation requires that a firm's strategic moves lower its costs and also increase the perceived value for buyers (see Exhibit 6.9). Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors that the firm's industry rivals compete on. Perceived buyer value is increased by raising existing key success factors and by creating new elements that the industry has not offered previously. To initiate a strategic move that allows a firm to open a new and uncontested market space through value innovation, managers must answer the four key questions below when formulating a blue ocean business strategy.⁴⁰ In terms of achieving successful value innovation, note that the first two questions focus on lowering costs, while the other two questions focus on increasing perceived consumer benefits.

Value Innovation—Lower Costs

1. *Eliminate.* Which of the factors that the industry takes for granted should be eliminated?
2. *Reduce.* Which of the factors should be reduced well below the industry's standard?

Value Innovation—Increase Perceived Consumer Benefits

3. *Raise.* Which of the factors should be raised well above the industry's standard?
4. *Create.* Which factors should be created that the industry has never offered?

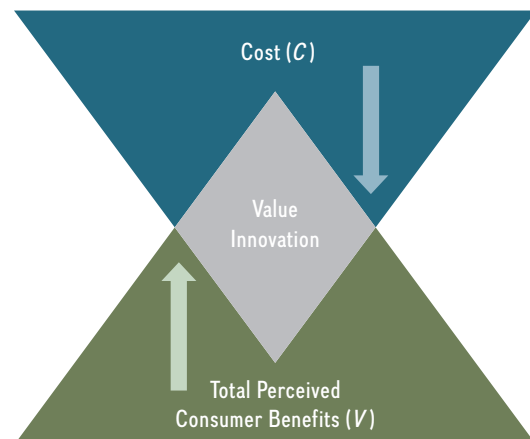
The international furniture retailer IKEA, for example, has used value innovation based on the *eliminate-reduce-raise-create* framework to initiate its own blue ocean and to achieve a sustainable competitive advantage.⁴¹

LO 6-5

Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

value innovation The simultaneous pursuit of differentiation and low cost in a way that creates a leap in value for both the firm and the consumers; considered a cornerstone of blue ocean strategy.

EXHIBIT 6.9 / Value Innovation Accomplished through Simultaneously Pursuing Differentiation ($V \uparrow$) and Low Cost ($C \downarrow$)



SOURCE: Adapted from C.W. Kim and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston, MA: Harvard Business School Publishing).

ELIMINATE. IKEA eliminated several taken-for-granted competitive elements: salespeople, expensive but small retail outlets in prime urban locations and shopping malls, long wait after ordering furniture, after-sales service, and other factors. In contrast, IKEA displays its products in a warehouse-like setting, thus reducing inventory cost. Customers serve themselves and then transport the furniture to their homes in IKEA's signature flat-packs for assembly. IKEA also uses the big-box concept of locating supersized stores near major metropolitan areas (please refer to the discussion of "Taking Advantage of Certain Physical Properties" under "Economies of Scale" in Section 6.3).

REDUCE. Because of its do-it-yourself business model regarding furniture selection, delivery, and assembly, IKEA drastically reduced the need for staff in its mega-stores. Strolling through an IKEA store, you encounter few employees. IKEA also reduced several other taken-for-granted competitive elements: 25-year warranties on high-end custom furniture, high degree of customization in selection of options such as different fabrics and patterns, and use of expensive materials such as leather or hardwoods, among other elements.

RAISE. IKEA raised several competitive elements: It offers tens of thousands of home furnishing items in each of its big-box stores (some 300,000 square feet, roughly five football fields), versus a few hundred at best in traditional furniture stores; it also offers more than furniture, including a range of accessories such as place mats, laptop stands, and much more; each store has hundreds of rooms fully decorated with all sorts of IKEA items, each with a detailed tag explaining the item. Moreover, rather than sourcing its furniture from wholesalers or other furniture makers, IKEA manufactures all of its furniture at fully dedicated suppliers, thus tightly controlling the design, quality, functionality, and cost of each product.

IKEA also raised the customer experience by laying out its stores in such a way that customers see and can touch basically all of IKEA's products, from wineglasses (six for \$2.99) to bookshelves (for less than \$100).

CREATE. IKEA created a new way for people to shop for furniture. Customers stroll along a predetermined path winding through the fully furnished showrooms. They can compare, test, and touch all the things in the showroom. The price tag on each item contains other important information: type of material, weight, and so on. Once an item is selected, the customer notes the item number (the store provides a pencil and paper). The tag also indicates the location in the warehouse where the customer can pick up the item in IKEA's signature flat-packs. After paying, the customer transports the products and assembles the furniture. The customer has 90 days to return items for a full refund.

In traditional furniture shopping, customers visit a small retail outlet where salespeople swarm them. After a purchase, the customer has to wait generally a few weeks before the furniture is shipped because many furniture makers do not produce items, such



Each IKEA store has a large self-service warehouse section.

©Alex Segre/Alamy Stock Photo

as expensive leather sofas, unless they are paid for in advance. Finely crafted couches and chairs cost thousands of dollars (while IKEA's fabric couches retail for \$399). When shopping at a traditional furniture store, the customer also pays for delivery of the furniture.

IKEA also created a new approach to pricing its products. Rather than using a “cost plus margin approach” like traditional furniture stores when pricing items, IKEA begins with the retail price first. For example, it sets the price for an office chair at \$150, and IKEA’s designers figure out how to meet this goal, which includes a profit margin. They need to consider the chair from start to finish, including not only design but also raw materials and the way the product will be displayed and transported. Only then will products go into production.

IKEA also created several other new competitive elements that allow it to offer more value to its customers: Stores provide on-site child care, include a cafeteria serving delicious food options including Swedish delicatessen such as smoked salmon at low prices, and offer convenient and ample parking, often in garages under the store, where escalators bring customers directly into the showrooms.

Taken together, with all these steps to eliminate, reduce, raise, and create, IKEA orchestrates different internal value chain activities to reconcile the tension between differentiation and cost leadership to create a unique market space. IKEA uses innovation in multiple dimensions—in furniture design, engineering, and store design—to solve the trade-offs between value creation and production cost. An IKEA executive highlights the difficulty of achieving value innovation as follows: “Designing beautiful-but-expensive products is easy. Designing beautiful products that are inexpensive and functional is a huge challenge.”⁴² IKEA leverages its deep design and engineering expertise to offer furniture that is stylish and functional and that can be easily assembled by the consumer. In this way, IKEA can pursue a blue ocean strategy based on value innovation to increase the perceived value of its products, while simultaneously lowering its cost and offering competitive prices. It opened a new market serving a younger demographic than traditional furniture stores. When young people the world over move into their own apartment or house, they frequently furnish it from IKEA.

BLUE OCEAN STRATEGY GONE BAD: “STUCK IN THE MIDDLE”

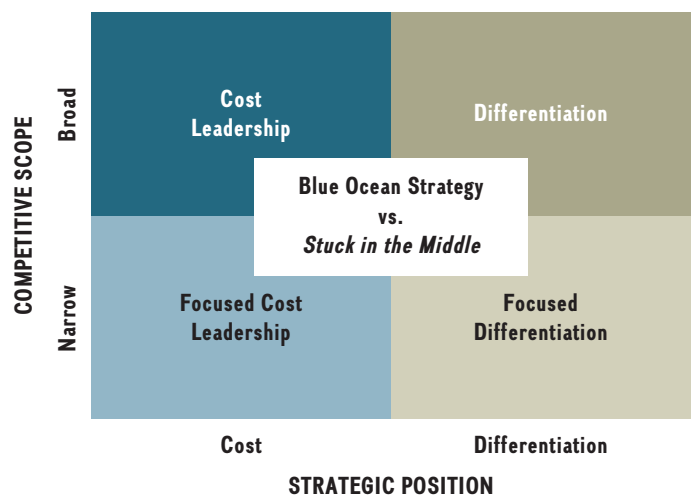
Although appealing in a theoretical sense, a blue ocean strategy can be quite difficult to translate into reality. Differentiation and cost leadership are distinct strategic positions that require important trade-offs.⁴³ A blue ocean strategy is difficult to implement because it requires the reconciliation of fundamentally different strategic positions—differentiation and low cost—which in turn require distinct internal value chain activities (see Chapter 4) so the firm can increase value *and* lower cost at the same time.

Exhibit 6.10 suggests how a successfully formulated blue ocean strategy based on *value innovation* combines both a differentiation and low-cost position. It also shows the consequence of a blue ocean strategy gone bad—the firm ends up being *stuck in the middle*, meaning the firm has neither a clear differentiation nor a clear cost-leadership profile. Being *stuck in the middle* leads to inferior performance and a resulting competitive disadvantage. Strategy Highlight 6.2 illustrates how JCPenney failed at a blue ocean strategy and ended up in the red ocean of cut-throat competition.

LO 6-6

Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

EXHIBIT 6.10 / Value Innovation vs. *Stuck in the Middle*



Strategy Highlight 6.2

How JCPenney Sailed Deeper into the Red Ocean

JCPenney under former CEO Ron Johnson learned the hard way how difficult it is to change a strategic position. When hired as JCPenney's CEO in 2011, Johnson was hailed as a star executive. He was poached from Apple, where he had created and led Apple's retail stores since 2000. Apple's stores are the most successful retail outlets globally in terms of sales per square foot. No other retail outlet, not even luxury jewelers, achieves more.

Once on board with JCPenney, Johnson immediately began to change the company's strategic position from a cost-leadership to a *blue ocean strategy*, attempting to combine the cost-leadership position with a differentiation position. In particular, he tried to reposition the department store more toward the high end by providing an improved customer experience and more exclusive merchandise through in-store boutiques. Johnson ordered all clearance racks with steeply discounted merchandise, common in JCPenney stores, to be removed. He also did away with JCPenney's long-standing practice of mailing discount coupons to its customers. Rather than following industry best practice by testing the more drastic strategic moves in a small number of selected stores, Johnson implemented them in all 1,800 stores at once. When one executive raised the issue of pretesting, Johnson bristled and responded: "We didn't test at Apple." Under his leadership, JCPenney also got embroiled in a legal battle with Macy's because of Johnson's attempt to lure away homemaking maven Martha Stewart and her exclusive merchandise collection.

The envisioned blue ocean strategy failed badly, and JCPenney ended up being stuck in the middle. Within 12 months with Johnson at the helm, JCPenney's sales dropped by 25 percent. In a hypercompetitive industry such as retailing where every single percent of market share counts, this was a landslide. In 2013, JCPenney's stock performed so poorly it was dropped from the S&P 500 index. Less than 18 months into his new job, Johnson was fired. Myron Ullman, his predecessor, was brought out of retirement as a temporary replacement.

JCPenney failed at its attempted blue ocean strategy and instead sailed deeper into the *red ocean* of bloody competition. This highlights the perils of attempting a blue ocean



JCPenney's new CEO, Marvin Ellison, is charged with turning the 115-year-old industry icon around. With a strong background in operations management and leadership skills honed at The Home Depot, he is focusing on lowering JCPenney's cost structure while increasing perceived value offered to its customers. ©MediaPunch Inc/Alamy Stock Photo

strategy because of the inherent trade-offs in the underlying generic business strategies of cost leadership and differentiation. As a result, JCPenney continues to experience a sustained competitive disadvantage as of this writing. In the decade preceding 2015, JCPenney underperformed the wider stock market (measured in the S&P 500 index) by almost 150 percentage points, with the gap widening over time. To turn around the 115-year-old company, the board appointed Marvin Ellison as CEO in 2015. Ellison came to JCPenney from The Home Depot, where he excelled as a strong leader focused on effective operations. In an attempt to stem losses, JCPenney closed some 140 retail stores across the United States out of a total of 1,000 outlets in 2017.⁴⁴

THE STRATEGY CANVAS The **value curve** is the basic component of the **strategy canvas**. It graphically depicts a company's relative performance across its industry's factors of competition. A strong value curve has focus and divergence, and it can even provide a kind of tagline as to what strategy is being undertaken or should be undertaken.

Exhibit 6.11 plots the strategic profiles or value curves for three kinds of competitors in the U.S. airline industry. On the left-hand side, descending in price, are the legacy carriers (for example, Delta), JetBlue, and finally low-cost airlines such as Southwest Airlines (SWA). We also show the different strategic positions (differentiator, stuck in the middle, and low-cost leader) and trace the value curves as they rank high or low on a variety of parameters. JetBlue is stuck in the middle (as discussed in the ChapterCase). Low-cost airlines follow a cost-leadership strategy. The value curve, therefore, is simply a graphic representation of a firm's relative performance across different competitive factors in an industry.

Legacy carriers tend to score highly among most competitive elements in the airline industry, including different seating class choices (such as first class, business class, economy comfort, basic economy, and so on), a high level of in-flight amenities such as Wi-Fi, personal video console to view movies or play games, complimentary drinks and meals, coast-to-coast coverage via connecting hubs, plush airport lounges, international routes and global coverage, high customer service, and high reliability in terms of safety and on-time departures and arrivals. As is expected when pursuing a generic differentiation strategy, all these scores along the different competitive elements in an industry go along with a relative higher cost structure.

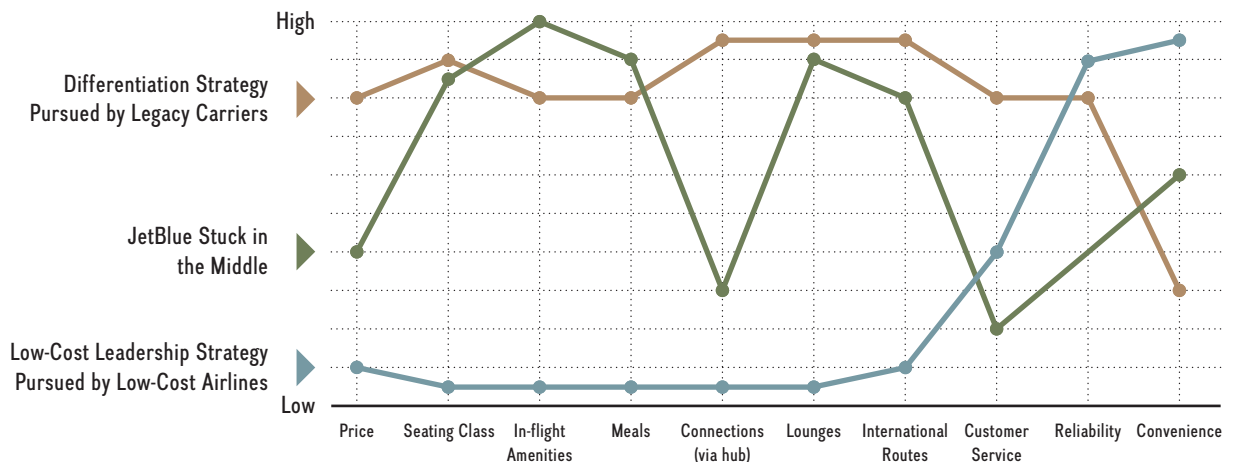
In contrast, the low-cost airlines tend to hover near the bottom of the strategy canvas, indicating low scores along a number of competitive factors in the industry, with no assigned seating, no in-flight amenities, no drinks or meals, no airport lounges, few if any international routes, low to intermediate level of customer service. A relatively lower cost structure goes along with a generic low-cost leadership strategy.

This strategy canvas also reveals key strategic insights. Look at the few competitive elements where the value curves of the differentiator and low-cost leader diverge.

value curve Horizontal connection of the points of each value on the strategy canvas that helps strategic leaders diagnose and determine courses of action.

strategy canvas Graphical depiction of a company's relative performance vis-à-vis its competitors across the industry's key success factors.

EXHIBIT 6.11 / Strategy Canvas of JetBlue vs. Low-Cost Airlines and Legacy Carriers



Interestingly, some cost leaders (e.g., SWA) score much higher than some differentiators (e.g., Delta) in terms of reliability and convenience, offering frequent point-to-point connections to conveniently located airports, often in or near city centers. This key divergence between the two strategies explains why generic cost leaders have frequently outperformed generic differentiators in the U.S. airline industry. Overall, both value curves show a consistent pattern representative of a more or less clear strategic profile as either differentiation or low-cost leader.

Now look at JetBlue's value curve. Rather than being consistent such as the differentiation or low-cost value curves, the JetBlue value curve follows a zigzag pattern. JetBlue attempts to achieve parity or even out-compete differentiators in the U.S. airline industry along the competitive factors such as different seating classes (e.g., the high-end Mint offering discussed in the ChapterCase), higher level of in-flight amenities, higher-quality beverages and meals, plush airport lounges, and a large number of international routes (mainly with global partner airlines). JetBlue, however, looks more like a low-cost leader in terms of the ability to provide only a few connections via hubs domestically, and it recently has had a poor record of customer service, mainly because of some high-profile missteps as documented in the ChapterCase. JetBlue's reliability is somewhat mediocre, but it does provide a larger number of convenient point-to-point flights than a differentiator such as Delta, but fewer than a low-cost leader such as SWA.

A value curve that zigzags across the strategy canvas indicates a lack of effectiveness in its strategic profile. The curve visually represents how JetBlue is *stuck in the middle* and as a consequence experienced inferior performance and thus a sustained competitive disadvantage vis-à-vis airlines with a stronger strategy profile such as SWA and Delta, among others.

6.6 Implications for Strategic Leaders

Strategy is never easy, even when, as in achieving competitive advantage, only a handful of strategic options are available (i.e., low cost or differentiation, broad or narrow, or blue ocean). The best managers work hard to make sure they understand their firm and industry effects, and the opportunities they reveal. They work even harder to fine-tune strategy formulation and execution. When well-formulated and implemented, a firm's business strategy enhances a firm's chances of obtaining superior performance. Strategic positioning requires making important trade-offs (think Walmart versus J. Crew in clothing).

In rare instances, a few exceptional firms might be able to change the competitive landscape by opening previously unknown areas of competition. To do so requires the firm reconcile the significant trade-offs between increasing value and lowering costs by pursuing both business strategies (differentiation and low cost) simultaneously. Such a blue ocean strategy tends to be successful only if a firm is able to rely on a value innovation that allows it to reconcile the trade-offs mentioned. Toyota, for example, initiated a new market space with its introduction of lean manufacturing, delivering cars of higher quality and value at lower cost. This value innovation allowed Toyota a competitive advantage for a decade or more, until this new process technology diffused widely. JCPenney, on the other hand, stumbled and found itself failing on most fronts, resulting in a sustained competitive disadvantage (see Strategy Highlight 6.2).

CHAPTERCASE 6 / Consider This . . .

Early in its history JetBlue Airways achieved a competitive advantage based on *value innovation*. In particular, JetBlue was able to drive up perceived customer value while lowering costs. This allowed it to carve out a strong strategic position and move to a non-contested market space. This implies that no other competitors in the U.S. domestic airline industry were able to provide such value innovation at that point in time. Rather than directly competing with other airlines, JetBlue created a blue ocean.

Although JetBlue was able to create an initial competitive advantage, the airline was unable to sustain it. Because JetBlue failed in reconciling the strategic trade-offs inherent in combining differentiation and cost leadership, it was unable to continue its blue ocean strategy, despite initial success. Between 2007 and 2015, JetBlue experienced a sustained competitive disadvantage, at one point lagging the Dow Jones U.S. Airlines Index by more than 180 percentage points in 2015.

A new leadership team CEO Robin Hayes put in place in early 2015 is attempting to reverse this trend. The new team made quick changes to improve the airline's flagging profitability. It is putting strategic initiatives in place to lower costs, while also trying to further increase its value offering. To lower operating costs, JetBlue decided to start charging \$50 per checked bag instead of offering it as a free service. It also removed the additional legroom JetBlue was famous for in the industry. To drive up perceived customer value, JetBlue is adding to its fleet a new airplane (Airbus A-321), which scores significantly higher in customer satisfaction surveys than the older A-320. Although JetBlue already flies internationally by serving destinations in Central and South America as well as the Caribbean, Hayes is considering adding selected flights to Europe. Flying non-stop to cities in Europe such as London is now possible with the new Airbus A-321. Flying longer, non-stop routes drives down costs. International routes, moreover, tend to be much more profitable than domestic routes because of less competition, for the time being.



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Questions

1. Despite its initial success, why was JetBlue unable to sustain a blue ocean strategy?
2. JetBlue's chief marketing officer, Marty St. George, was asked by *The Wall Street Journal*, "What is the biggest marketing challenge JetBlue faces?" His response: "We are flying in a space where our competitors are moving toward commoditization. We have taken a position that air travel is not a commodity but a services business. We want to stand out, but it's hard to break through to customers with that message."⁴⁵
 - a. Given St. George's statement, which strategic position is JetBlue trying to accomplish: differentiator, cost leader, or blue ocean strategy? Explain why.
 - b. Which strategic moves has the new CEO put in place, and why? Explain whether they focus on value creation, operating costs, or both simultaneously. Do these moves correspond to St. George's understanding of JetBlue's strategic position? Why or why not? Explain.
3. Consider JetBlue's value curve in Exhibit 6.11. Why is JetBlue experiencing a competitive disadvantage? What recommendations would you offer to JetBlue to strengthen its strategic profile? Be specific.
4. JetBlue CEO Robin Hayes is contemplating adding international routes, connecting the U.S. East Coast to Europe. Would this additional international expansion put more pressure on JetBlue's current business strategy? Or would this international expansion require a shift in JetBlue's strategic profile? Why or why not? And if a strategic repositioning is needed, in which direction should JetBlue pivot? Explain.

TAKE-AWAY CONCEPTS

This chapter discussed two generic business-level strategies: *differentiation* and *cost leadership*. Companies can use various tactics to drive one or the other of those strategies, either narrowly or broadly. A *blue ocean*

strategy attempts to find a competitive advantage by creating a new competitive area, which it does (when successful) by value innovation, reconciling the trade-offs between the two generic business strategies discussed.

These concepts are summarized by the following learning objectives and related take-away concepts.

LO 6-1 / Define business-level strategy and describe how it determines a firm's strategic position.

- Business-level strategy determines a firm's strategic position in its quest for competitive advantage when competing in a single industry or product market.
- Strategic positioning requires that managers address strategic trade-offs that arise between value and cost, because higher value tends to go along with higher cost.
- Differentiation and cost leadership are distinct strategic positions.
- Besides selecting an appropriate strategic position, managers must also define the scope of competition—whether to pursue a specific market niche or go after the broader market.

LO 6-2 / Examine the relationship between value drivers and differentiation strategy.

- The goal of a differentiation strategy is to increase the perceived value of goods and services so that customers will pay a higher price for additional features.
- In a differentiation strategy, the focus of competition is on value-enhancing attributes and features, while controlling costs.
- Some of the unique value drivers managers can manipulate are product features, customer service, customization, and complements.
- Value drivers contribute to competitive advantage only if their increase in value creation (ΔV) exceeds the increase in costs, that is: $(\Delta V) > (\Delta C)$.

LO 6-3 / Examine the relationship between cost drivers and cost-leadership strategy.

- The goal of a cost-leadership strategy is to reduce the firm's cost below that of its competitors.
- In a cost-leadership strategy, the focus of competition is achieving the lowest possible cost position, which allows the firm to offer a lower price than competitors while maintaining acceptable value.
- Some of the unique cost drivers that managers can manipulate are the cost of input factors, economies of scale, and learning- and experience-curve effects.
- No matter how low the price, if there is no acceptable value proposition, the product or service will not sell.

LO 6-4 / Assess the benefits and risks of differentiation and cost-leadership strategies vis-à-vis the five forces that shape competition.

- The five forces model helps managers use generic business strategies to protect themselves against the industry forces that drive down profitability.
- Differentiation and cost-leadership strategies allow firms to carve out strong strategic positions, not only to protect themselves against the five forces, but also to benefit from them in their quest for competitive advantage.
- Exhibit 6.8 details the benefits and risks of each business strategy.

LO 6-5 / Evaluate value and cost drivers that may allow a firm to pursue a blue ocean strategy.

- To address the trade-offs between differentiation and cost leadership at the business level, managers must employ value innovation, a process that will lead them to align the proposed business strategy with total perceived consumer benefits, price, and cost.
- Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors on which the firm's industry rivals compete.
- Increasing perceived buyer value is primarily achieved by raising existing key success factors and by creating new elements that the industry has not yet offered.
- Strategic leaders track their opportunities and risks for lowering a firm's costs and increasing perceived value vis-à-vis their competitors by use of a strategy canvas, which plots industry factors among competitors (see Exhibit 6.11).

LO 6-6 / Assess the risks of a blue ocean strategy, and explain why it is difficult to succeed at value innovation.

- A successful blue ocean strategy requires that trade-offs between differentiation and low cost be reconciled.
- A blue ocean strategy often is difficult because the two distinct strategic positions require internal value chain activities that are fundamentally different from one another.
- When firms fail to resolve strategic trade-offs between differentiation and cost, they end up being "stuck in the middle." They then succeed at neither business strategy, leading to a competitive disadvantage.

KEY TERMS

Blue ocean strategy (p. 204)	Focused cost-leadership strategy (p. 188)	Strategic trade-offs (p. 186)
Business-level strategy (p. 185)	Focused differentiation strategy (p. 188)	Strategy canvas (p. 209)
Cost-leadership strategy (p. 187)	Minimum efficient scale (MES) (p. 195)	Value curve (p. 209)
Differentiation strategy (p. 186)	Scope of competition (p. 187)	Value innovation (p. 205)
Diseconomies of scale (p. 196)		
Economies of scale (p. 194)		
Economies of scope (p. 190)		

DISCUSSION QUESTIONS

1. What are some drawbacks and risks to a broad generic business strategy? To a focused strategy?
2. In Chapter 4, we discussed the internal value chain activities a firm can perform (see Exhibit 4.7). The value chain priorities can be quite different for firms taking different business strategies. Create examples of value chains for three firms: one using cost leadership, another using differentiation, and a third using value innovation business-level strategy.
3. The chapter notes there are key differences between economies of scale and learning effects. Let us put that into practice with a brief example.
A company such as Intel has a complex design and manufacturing process. For instance,

one fabrication line for semiconductors typically costs more than \$1.5 billion to build. Yet the industry also has high human costs for research and development (R&D) departments. Semiconductor firms spend an average of 17 percent of revenues on R&D. For comparison the automobile industry spends a mere 3 percent of sales on R&D.⁴⁶ Thus Intel's management must be concerned with both scale of production and learning curves. When do you think managers should be more concerned with large-scale production runs, and when do you think they should be most concerned with practices that would foster or hinder the hiring, training, and retention of key employees?

ETHICAL/SOCIAL ISSUES

1. Suppose Procter & Gamble (P&G) learns that the relatively new start-up company Method (www.methodhome.com) is gaining market share with a new laundry detergent in West Coast markets. In response, P&G lowers the price of its Tide detergent from \$18 to \$9 for a 150-ounce bottle only in markets where Method's product is for sale. The goal of this "loss leader" price drop is to encourage Method to leave the laundry detergent market. Is this an ethical business practice? Why or why not?
2. In the chapter discussion on value innovation, IKEA is noted as a firm that has successfully applied these techniques. What roles, if any, do sustainability and triple-bottom-line factors have in the success of IKEA as a leader in the furniture industry? (See Chapter 5.)

SMALL GROUP EXERCISES

//// SMALL GROUP EXERCISE 1

Ryanair based in Dublin, Ireland, has been renowned in Europe as a firm that can make a profit on a \$20 ticket by imposing numerous fees and surcharges. The airline has sought to be the lowest of the low-cost providers in the EU with a “no frills get you from point A to B model.” Ryanair is on record as saying it wants to be the “Amazon.com of travel in Europe” by bringing in competitors’ price comparison, hotel discounts, and even concert tickets.⁴⁷ Check out the company website (www.ryanair.com) and consider the questions that follow.

1. If you were a competitor in the European market, such as British Airways or Lufthansa, how would you compete against Ryanair, knowing your cost structure would not allow price parity? If you were a low-cost leader like EasyJet, how would you compete against Ryanair?
2. What similarities and differences do you find about RyanAir compared to Jet Blue from ChapterCase 6?

//// SMALL GROUP EXERCISE 2

This chapter discusses several firms in the retailing environment. Strategy Highlight 6.2 for example covers the struggles JCPenney has had in recent years and the closing of 140 stores across the United States. JC Penney

is far from alone in having performance challenges. By March 2017, 21 retailers (including Macy’s, Sears, and The Limited) had announced the closure of over 3,500 stores affecting more than 50,000 jobs just in 2017. Several factors are impacting the retailing industry. For example, consumer behavior in developed countries is shifting from shopping trips to social experiences. In 2016 the amount of money spent in restaurants and bars for the first time surpassed that spent in grocery stores across the United States. Complicating matters for stores such as JCPenney, Macy’s, and Nordstrom, which are largely based in malls, is a 2017 report that showed the United States had 1,200 malls and probably needs less than 900. On a per capita basis, the United States has 40 percent more shopping space than Canada and a remarkable 1,000 percent more than Germany.⁴⁸

1. The retail department store is clearly a red ocean space right now. Your team has been asked to consult for Simon Property Group (SPG in NYSE), one of the largest U.S. operators of shopping malls. The company wants to know how its mall space could be repurposed. What blue ocean ideas can your team develop to present to the executives at Simon? Consider the positives and negatives of typical mall sizes and locations in your answer. Stretch beyond traditional retailing for ideas to consider.

mySTRATEGY

Low-Cost and Differentiated Workplaces

We have studied the differences in business-level strategies closely in this chapter, but how might these differences relate directly to you? As you’ve learned, firms using a differentiation strategy will focus on drivers such as product features and customer service, while firms using a cost-leadership strategy will prioritize cost of inputs and economies of scale. These strategic decisions can have an impact on an employee’s experience with the firm’s work environment and culture.

Nordstrom, Whole Foods Market (before its 2017 acquisition by Amazon), and Wegmans Food Markets are companies

that routinely end up on *Fortune*’s list of “100 Best Places to Work.” These companies use a differentiation business strategy. In contrast, Amazon and Walmart use the cost-leadership strategy; and as low-cost leaders, they do not rate nearly as well. According to inputs from the employee review site Glassdoor.com, only 50 percent of the employees working at Walmart would recommend the firm to a friend. Compare this to the 72 percent who would recommend both Nordstrom and Whole Foods, and the 80 percent who would recommend Wegmans Food Markets. As for Whole Foods, some industry watchers believe Amazon will enact the same tactics in dealing with workers at Whole Foods as it has applied to its own warehouse workers, leading to a low rating of employee satisfaction.

As you seek options for starting or growing your career, carefully consider the strategy the firm takes in the marketplace. By no means

should you avoid low-cost leaders in lieu of strong differentiators (nor should you deem all differentiators as great places to work). Fast-paced organizations that focus on driving tangible results for the organization offer much to learn. For example, Amazon has been a very successful company for the past decade, and many employees have had multiple opportunities to learn enormous amounts in a short period. The firm has also made HR and cultural changes after a scathing *New York Times* article about its “bruising workplace.” Amazon has reportedly eliminated the practice of forcing employee rankings to follow a normal curve with only a small percentage getting top scores.

Amazon employees are encouraged to criticize each other’s ideas openly in meetings; they work long days and on weekends; and they strive to meet “unreasonably high” standards. “When you’re shooting for the moon, the nature of the work is really challenging. For some people it doesn’t work,” says Susan Harker, a top recruiter for Amazon. The high standards and relentless pace are a draw for many employees who are motivated to push themselves to learn, grow, and create—perhaps beyond their perceived limits. Many former employees say the nimble and productive environment is great for learning and

the Amazon experience has really helped their careers expand. Now consider the following questions.

1. Employees and consultants say the Amazon workplace is the epitome of a “do more for less cost” environment. We recognize this is a hallmark goal of a cost-leadership business strategy. But ask yourself this key question, *Is it the type of high-pressure work environment in which YOU would thrive?*
2. Amazon has surpassed 350,000 employees, adding more than 100,000 employees in 2016 alone! The company will be offering bold new ideas and moving Amazon toward being the first trillion-dollar retailer under an intense pressure to deliver on its goals. The allure from this type of success is compelling and offers tremendous rewards to many employees, shareholders, and customers. What aspects of success are you seeking in your professional career?
3. Before you launch into a new project, job, or firm, or even before you make a change in industry in the effort to move forward in your career, always consider the trade-offs that you would and would not be willing to make.⁴⁹

ENDNOTES

1. This ChapterCase is based on: McCartney, S. (2017, Mar. 8), “Discount business class? Thank JetBlue,” *The Wall Street Journal*; Leahy, J. (2017, Apr. 17), “Azul float raises hopes for Brazil’s stalled IPO market,” *Financial Times*; Lovelace Jr., B. (2017, Apr. 11), “Brazilian airline Azul begins trading at the NYSE, shoots 8% higher,” *CNBC*; Carey, S. (2016, Dec. 16), “JetBlue unveils cost-cutting plan worth up to \$300 million by 2020,” *The Wall Street Journal*; Carey, S. (2016, Jul. 26), “JetBlue considers foray into Europe,” *The Wall Street Journal*; Carey, S. (2016, Apr. 12), “JetBlue to expand its high-end service, dubbed Mint, to more routes,” *The Wall Street Journal*; Nicas, J. (2015, Mar. 27), “Pilot sues JetBlue for allegedly letting him fly while mentally unfit,” *The Wall Street Journal*; Mayerowitz, S. (2015, Feb. 16), “JetBlue’s CEO vies to please passengers, stocks,” *The Associated Press*; Vranica, S. (2015, Feb. 22), “JetBlue’s plan to repair its brand,” *The Wall Street Journal*; Harris, R.L. (2015, Feb. 11), “On JetBlue, passengers can use ApplePay,” *The New York Times*; Rosenbloom, S. (2015, Jan. 22), “Flying deluxe domestic coast-to-coast for around \$1,000,” *The New York Times*; Nicas, J. (2014, Nov. 19), “JetBlue to add bag fees, reduce legroom,” *The Wall Street Journal*; Gardiner, S. (2010, Aug. 10), “Flight attendant

grabs two beers, slides down the emergency chute,” *The Wall Street Journal*; “Can JetBlue weather the storm?” *Time*, February 21, 2007; “Held hostage on the tarmac: Time for a passenger bill of rights?” *The New York Times*, February 16, 2007; Bryce, D.J., and J.H. Dyer (2007), “Strategies to crack well-guarded markets,” *Harvard Business Review*, May; Kim, C.W., and R. Mauborgne (2005), *Blue Ocean Strategy: How to Create Uncontested Market Space and Make Competition Irrelevant* (Boston, MA: Harvard Business School Publishing); Friedman, T. (2005), *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Strauss and Giroux); and Neeleman, D. (2003, Apr. 30), “Entrepreneurial thought leaders lecture,” *Stanford Technology Ventures Program*.

2. This discussion is based on: Porter, M.E. (2008, Jan.), “The five competitive forces that shape strategy,” *Harvard Business Review*; Porter, M.E. (1996), “What is strategy?” *Harvard Business Review*, November–December; Porter, M.E. (1985), *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press); and Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press).

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4. The discussion of generic business strategies is based on: Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); Porter, M.E. (1985), *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press); Porter, M.E. (1996), “What is strategy?” *Harvard Business Review*, November–December; and Porter, M.E. (2008, Jan.), “The five competitive forces that shape strategy,” *Harvard Business Review*.

5. Porter, M.E. (1996), “What is strategy?” *Harvard Business Review*, November–December.

6. To decide if and how to divide the market, you can apply the market segmentation techniques you have acquired in your marketing and microeconomics classes.

7. For sources on JetBlue, see: McCartney, S. (2017, Mar. 8), “Discount business class?”

Thank JetBlue,” *The Wall Street Journal*; Leahy, J. (2017, Apr. 17), “Azul float raises hopes for Brazil’s stalled IPO market,” *Financial Times*; Lovelace Jr., B. (2017, Apr. 11), “Brazilian airline Azul begins trading at the NYSE, shoots 8% higher,” *CNBC*; Carey, S. (2016, Dec. 16), “JetBlue unveils cost-cutting plan worth up to \$300 million by 2020,” *The Wall Street Journal*; Carey, S. (2016, Jul. 26), “JetBlue considers foray into Europe,” *The Wall Street Journal*; Carey, S. (2016, Apr. 12), “JetBlue to expand its high-end service, dubbed Mint, to more routes,” *The Wall Street Journal*; Nicas, J. (2015, Mar. 27), “Pilot sues JetBlue for allegedly letting him fly while mentally unfit,” *The Wall Street Journal*; Mayerowitz, S. (2015, Feb. 16), “JetBlue’s CEO vies to please passengers, stocks,” *The Associated Press*; Vranica, S. (2015, Feb. 22), “JetBlue’s plan to repair its brand,” *The Wall Street Journal*; Harris, R.L. (2015, Feb. 11), “On JetBlue, passengers can use ApplePay,” *The New York Times*; Rosenbloom, S. (2015, Jan. 23), “Flying deluxe domestic coast-to-coast for around \$1,000,” *The New York Times*; Nicas, J. (2014, Nov. 19), “JetBlue to add bag fees, reduce legroom,” *The Wall Street Journal*; Gardiner, S. (2010, Aug. 10), “Flight attendant grabs two beers, slides down the emergency chute,” *The Wall Street Journal*; “Can JetBlue weather the storm?” *Time*, February 21, 2007; “Held hostage on the tarmac: Time for a passenger bill of rights?” *The New York Times*, February 16, 2007; Bryce, D.J., and J.H. Dyer (2007, May), “Strategies to crack well-guarded markets,” *Harvard Business Review*; Friedman, T. (2005), *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Strauss and Giroux); and Neeleman, D. (2003, Apr. 30), “Entrepreneurial thought leaders lecture,” *Stanford Technology Ventures Program*.

8. This example is drawn from “Companies are racing to add value to water,” *The Economist*, March 25, 2017.

9. Christensen, C.M., and M.E. Raynor (2003), *The Innovator’s Solution: Creating and Sustaining Successful Growth* (Boston, MA: Harvard Business School Press).

10. The interested reader is referred to the strategy, marketing, and economics literatures. A good start in the strategy literature is the classic work of M.E. Porter: Porter, M.E. (1980), *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press); Porter, M.E. (1985), *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press); and Porter, M.E. (2008, Jan.), “The five competitive forces that shape strategy,” *Harvard Business Review*.

11. www.oxo.com/about.jsp.

12. Hsieh, T. (2010), *Delivering Happiness: A Path to Profits, Passion, and Purpose* (New York: Business Plus).

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14. “Where in the Dickens can you find a Trader Joe’s,” store listing at www.traderjoes.com/pdf/locations/all-locations.pdf; “Ten companies with excellent customer service,” *Huffington Post*, August 15, 2014, http://www.huffingtonpost.com/2013/08/15/best-customer-service_n_3720052.html.

15. Olivarez-Giles, N. (2015, Jul. 7), “Project Fi review: Google masters Wi-Fi calling, but needs better phones,” *The Wall Street Journal*; Duran M. (2015, Jul. 7), “Google’s Project Fi wireless service is crazy cheap. But should you switch?” *Wired*.

16. “Flights of hypocrisy,” *The Economist*, April 25, 2015.

17. “Boeing 787: Orders and Deliveries (updated monthly),” *The Boeing Co.*, March 2015, www.boeing.com.

18. www.airbus.com/en/aircraftfamilies/a380/home/.

19. Microsoft Annual Report (various years).

20. “Nucor’s new plant project still on hold,” *The Associated Press*, July 23, 2009; www.nucor.com.

21. On strategy as simple rules, see: Sull, D., and K.M. Eisenhardt (2015), *Simple Rules: How to Thrive in a Complex World* (New York: Houghton Mifflin Harcourt).

22. Gladwell, M. (2002), *The Tipping Point: How Little Things Can Make a Big Difference* (New York: Back Bay Books), 185.

23. Levitt, B., and J.G. March (1988), “Organizational learning,” *Annual Review of Sociology* 14: 319–340.

24. For insightful reviews and syntheses on the learning-curve literature, see: Argote, L., and G. Todorova (2007), “Organizational learning: Review and future directions,” *International Review of Industrial and Organizational Psychology* 22: 193–234; and Yelle, L.E. (1979), “The learning curve: Historical review and comprehensive survey,” *Decision Sciences* 10: 302–308.

25. Wright, T.P. (1936), “Factors affecting the cost of airplanes,” *Journal of Aeronautical Sciences* 3: 122–128.

26. The Tesla example draws on: Dyer, J., and H. Gregersen (2016, Aug. 24), “Tesla’s innovations are transforming the auto industry,” *Forbes*; Higgins T. (2017, Apr. 10), “How Tesla topped GM as most valuable U.S. automaker,” *The Wall Street Journal Tech Talk*; “Tesla increases deliveries of electric cars,” *The Economist*, April 6, 2017; Tesla Annual Reports (various years); and GM Annual Reports (various years).

27. Dyer, J., and H. Gregersen (2016, Aug. 24), “Tesla’s innovations are transforming the auto industry,” *Forbes*. The authors (in conjunction

with David Kryscynski of Brigham Young University) estimate that the functional relationship between production volume and production cost for Tesla’s Model S between 2012 and 2014 is $Y=1726.5*(X^{-0.363})$

Data underlying Exhibit 6.6:

Units	Per-Unit Cost (\$)
100	\$324,464
500	\$180,901
1,000	\$140,659
1,500	\$121,407
2,000	\$109,369
2,500	\$100,859
3,000	\$94,400
3,500	\$89,263
4,000	\$85,039
4,500	\$81,480
5,000	\$78,422
5,500	\$75,756
6,000	\$73,400
6,500	\$71,298
7,000	\$69,406
7,500	\$67,689
8,000	\$66,122
8,500	\$64,683
9,000	\$63,354
9,500	\$62,123
10,000	\$60,977
10,500	\$59,907
11,000	\$58,903
11,500	\$57,961
12,000	\$57,072

28. The exact data for learning curves depicted in Exhibit 6.7 are depicted below. A simplifying assumption is that the manufacturing of one aircraft costs \$100 million, from there the two different learning curves set in. Noteworthy, that while making only one aircraft costs \$100 million, when manufacturing over 4,000 aircraft the expected per-unit cost falls to only \$28 million (assuming a 90 percent learning curve) and only \$7 million (assuming an 80 percent learning curve).

Data underlying Exhibit 6.7

Units	Learning Curves	
	Per-Unit Cost*	
	90%	80%
1	\$100	\$100
2	90	80
4	81	64

8	73	51
16	66	41
32	59	33
64	53	26
128	48	21
256	43	17
512	39	13
1,024	35	11
2,048	31	9
4,096	28	7

* Rounded to full dollar value in millions.

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CHAPTER

7

Business Strategy: Innovation, Entrepreneurship, and Platforms

Chapter Outline

- 7.1** Competition Driven by Innovation
The Innovation Process
- 7.2** Strategic and Social Entrepreneurship
- 7.3** Innovation and the Industry Life Cycle
Introduction Stage
Growth Stage
Shakeout Stage
Maturity Stage
Decline Stage
Crossing the Chasm
- 7.4** Types of Innovation
Incremental vs. Radical Innovation
Architectural vs. Disruptive Innovation
- 7.5** Platform Strategy
The Platform vs. Pipeline Business Models
The Platform Ecosystem
- 7.6** Implications for Strategic Leaders

Learning Objectives

- LO 7-1** Outline the four-step innovation process from idea to imitation.
- LO 7-2** Apply strategic management concepts to entrepreneurship and innovation.
- LO 7-3** Describe the competitive implications of different stages in the industry life cycle.
- LO 7-4** Derive strategic implications of the crossing-the-chasm framework.
- LO 7-5** Categorize different types of innovations in the markets-and-technology framework.
- LO 7-6** Explain why and how platform businesses can outperform pipeline businesses.

Netflix: Disrupting the TV Industry

JUST LIKE CABLE content providers disrupted the broadcast model of television, companies streaming video on demand are now disrupting the television industry once again.

The disruption by cable content providers played out in the 1980s and 1990s, upsetting a handful of broadcast networks with cable's dozens and then hundreds of channels. The current wave of disruption started in the 2000s, bypassing old-line cable content providers for direct online streaming. Now a multitude of devices—TV, PC, laptop, tablet, smartphone—provides a screen for online streaming. Netflix, riding atop the crest of this wave to industry leadership and competitive advantage, accounts for more than one-third of all downstream internet traffic in the United States during peak hours!

How did Netflix get here? It started as an obscure online shop renting DVDs delivered through U.S. mail. After being annoyed at having to pay more than \$40 in late fees for a Blockbuster video, Reed Hastings started Netflix in 1997 to offer online rentals of DVDs. At the time, the commercial internet was in its infancy; Amazon had just made its IPO in the same year. Streaming content may have been only a distant dream in the era of dial-up internet, but Netflix got a head start by turning from the dwindling VHS format and dealing with DVDs, which were cheaper and easier to mail. An improved business model helped too.

In 1999 Netflix rolled out a monthly subscription model, with unlimited rentals for a single monthly rate (and no late fees!). Rental DVDs were sent in distinctive red envelopes, with preprinted return envelopes. New rentals would not be sent until the current rental was returned.

Even with an innovative business model, Netflix got off to a slow start. By 2000, it had only about 300,000 subscribers and was losing money. Hastings approached Blockbuster, at the time the largest brick-and-mortar video rental chain with almost 8,000 stores in the United

States. He proposed selling Blockbuster 49 percent of Netflix and rebranding it as Blockbuster.com. Basically the idea was that Netflix would become the online presence for the huge national chain. The dot-com bubble had just burst, and Blockbuster turned Netflix down cold. Netflix, however, survived the dot-com bust, and by 2002, the company was profitable and went public. Blockbuster began online rentals in 2004, but by this time, Netflix already had a subscriber base of almost 4 million and a strong brand identity. Blockbuster lost 75 percent of its market value



House of Cards, a Netflix original series, stars Kevin Spacey and Robin Wright.
©A-Pix Entertainment/Photofest

between 2003 and 2005. From there it went from bad to worse. In 2010, the once mighty Blockbuster filed for bankruptcy.

Netflix was at the forefront of the current wave of disruption in the TV industry as it began streaming content over the internet in 2007. And it stayed at the forefront. It

adjusted quickly to the new options consumers had to receive content, making streaming available on a large number of devices including mobile phones, tablets, game consoles, and new devices dedicated to internet content streaming such as Roku, Apple TV, and Google Chromecast. At the same time, more and more Americans were signing up for high-speed broadband internet connections, making streaming content a much more enjoyable experience. The market for internet-connected, large, high-definition flat-screen TVs also began to take off. Within just two years, Netflix subscriptions (then priced at \$7.99 per month) jumped to 12 million.

Old-line media executives continued to dismiss Netflix as a threat. In 2010, Time Warner CEO Jeff Bewkes snubbed Netflix, saying, “It’s a little bit like, is the Albanian army going to take over the world? I don’t think so.”¹

Even Reed Hastings called what Netflix provided “rerun TV.” But behind their bravado, the broadcast networks were waking up to the Netflix threat. They stopped distributing content to Netflix and instead made it available through Hulu.com, an online content website jointly owned by several major networks. In 2011, Hulu began offering original content that was not available on broadcast or cable television. With its lower-cost structure, the networks saw Hulu’s

streaming model as a way to test new series ideas with minimal financial risk. In response, Netflix announced a move to create and stream original content online.

But not on the cheap. Since content streaming was Netflix’s main business, it devoted significant resources to produce high-quality content. In 2013, Netflix released the political drama *House of Cards*, followed, among others, by the comedy-drama *Orange Is the New Black* and *The Crown*, a biographical series about Queen Elizabeth II. These shows proved tremendous hits and have received many Emmys and Golden Globes.

In 2017, Netflix had 100 million subscribers worldwide, 51 million in the United States. Its revenues were \$9 billion, and its market cap was more than \$60 billion. Over the past decade, Netflix’s stock appreciated by more than 4,200 percentage points, while the tech-heavy NASDAQ-100 index grew by “only” 192 percentage points in the same period. By innovating on many dimensions, Netflix was able to not only disrupt the TV industry, but also to gain a competitive advantage.²

You will learn more about Netflix by reading this chapter; related questions appear in “ChapterCase 7 / Consider This. . . .”



INNOVATION the successful introduction of a new product, process, or business model—is a powerful driver in the competitive process. The ChapterCase provides an example of how innovations in technology and business models can make existing competitors obsolete, and how they allowed Netflix to gain a competitive advantage.

Continued innovation forms the bedrock of Netflix’s business strategy. Using big data analytics, in particular, Netflix introduced a number of early innovations in the video rental business. One of the more ingenious moves by Netflix was to have each user build a queue of movies he or she wanted to watch next. This allowed Netflix to predict future demand for specific movies fairly accurately. Another innovation was to create a “personalized recommendation engine” for each user that would predict what each subscriber might want to watch next based not only on a quick rating survey and the subscriber’s viewing history, but also what movies users with a similar profile had watched and enjoyed. Based on Netflix’s proprietary learning algorithm, the recommendations would improve over time as the user’s preferences become more clear. This also allowed Netflix to steer users away from hit movies (where wait times for DVD rentals were long because the company only had a limited number in its library) to lesser-known titles in its catalog. The ability to bring in the *long tail*³ of demand delighted not only viewers, as they enjoyed lesser-known, but often critically acclaimed films, but also movie studios, which could now make additional money on movies that would otherwise not be in demand. Moreover, in contrast to other players in the media industry, Netflix was fast to catch the wave of content streaming via the internet.

Innovation allows firms to redefine the marketplace in their favor and achieve a competitive advantage.⁴ That’s why we focus on innovation and the related topic of entrepreneurship in this chapter—to celebrate innovation as a powerful competitive weapon for business strategy formulation. We begin this chapter by detailing how competition is a process driven by continuous innovation. Next we discuss strategic and social entrepreneurship. We then

take a deep dive into the industry life cycle. This helps us to formulate a more dynamic business strategy as the industry changes over time. We also introduce the crossing-the-chasm framework, highlighting the difficulties in transitioning through different stages of the industry life cycle. We then move into a detailed discussion of different types of innovation using the markets-and-technology framework. We next present insights on how to compete in two-sided markets when discussing platform strategy. As with every chapter, we conclude with practice-oriented *Implications for Strategic Leaders*.

7.1 Competition Driven by Innovation

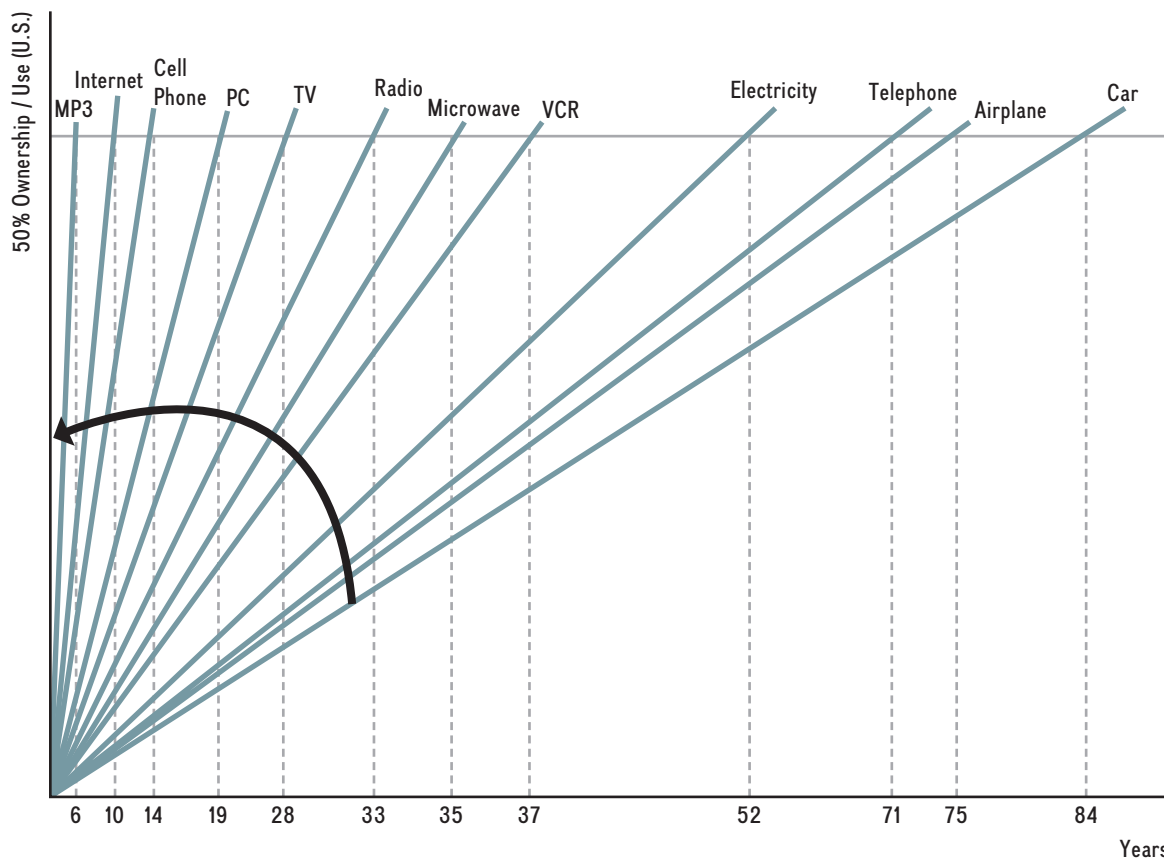
Competition is a process driven by the “perennial gale of creative destruction,” in the words of famed economist Joseph Schumpeter.⁵ The continuous waves of market leadership changes in the TV industry, detailed in the ChapterCase, demonstrate the potency of innovation as a competitive weapon: It can simultaneously create and destroy value. Firms must be able to innovate while also fending off competitors’ imitation attempts. A successful strategy requires both an effective offense and a hard-to-crack defense.

Many firms have dominated an early wave of innovation only to be challenged and often destroyed by the next wave. As highlighted in the ChapterCase, traditional television networks (ABC, CBS, and NBC) have been struggling to maintain viewers and advertising revenues as cable and satellite providers offered innovative programming. Those same cable and satellite providers now are trying hard to hold on to viewers as more and more people gravitate toward customized content online. To exploit such opportunities, Google acquired YouTube, while Comcast, the largest U.S. cable operator, purchased NBC-Universal.⁶ Comcast’s acquisition helps it integrate delivery services and content, with the goal of establishing itself as a new player in the media industry. In turn, both traditional TV and cable networks are currently under threat from content providers that stream via the internet, such as Netflix, YouTube, and Amazon.

As the adage goes, change is the only constant—and the rate of technological change has accelerated dramatically over the past hundred years. Changing technologies spawn new industries, while others die. This makes innovation a powerful strategic weapon to gain and sustain competitive advantage. Exhibit 7.1 shows how many years it took for different technological innovations to reach 50 percent of the U.S. population (either through ownership or usage). As an example, it took 84 years for half of the U.S. population to own a car, but only 28 years for half the population to own a TV. The pace of the adoption rate of recent innovations continues to accelerate. It took 19 years for the PC to reach 50 percent ownership, but only 6 years for MP3 players to accomplish the same diffusion rate.

What factors explain increasingly rapid technological diffusion and adoption? One determinant is that initial innovations such as the car, airplane, telephone, and the use of electricity provided the necessary infrastructure for newer innovations to diffuse more rapidly. Another reason is the emergence of new business models that make innovations more accessible. For example, Dell’s direct-to-consumer distribution system improved access to low-cost PCs, and Walmart’s low-price, high-volume model used its sophisticated IT logistics system to fuel explosive growth. In addition, satellite and cable distribution systems facilitated the ability of mass media such as radio and TV to deliver advertising and information to a wider audience. The speed of technology diffusion has accelerated further with the emergence of the internet, social networking sites, and viral messaging. Amazon continues to drive increased convenience, higher efficiency and lower costs in retailing. The accelerating speed of technological changes has significant implications for the competitive process and firm strategy. We will now take a close look at the innovation process unleashed by technological changes.

EXHIBIT 7.1 / Accelerating Speed of Technological Change



SOURCE: Depiction of data from the U.S. Census Bureau, the Consumer Electronics Association, *Forbes*, and the National Cable and Telecommunications Association.

LO 7-1

Outline the four-step innovation process from idea to imitation.

THE INNOVATION PROCESS

Broadly viewed, innovation describes the discovery, development, and transformation of new knowledge in a four-step process captured in the *four I's*: *idea*, *invention*, *innovation*, and *imitation* (see Exhibit 7.2).⁷

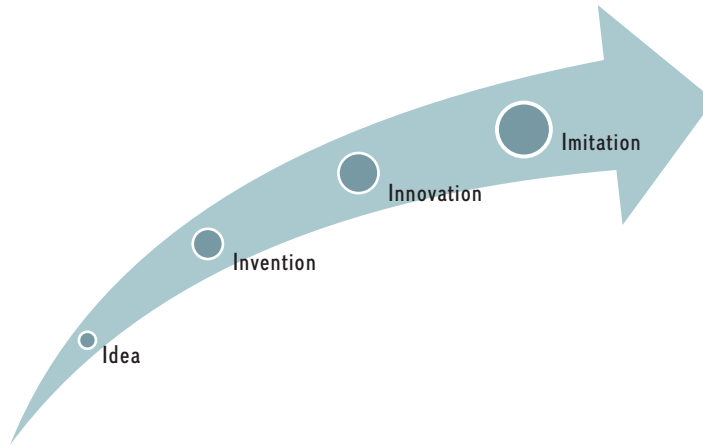
The innovation process begins with an *idea*. The idea is often presented in terms of abstract concepts or as findings derived from basic research. Basic research is conducted to discover new knowledge and is often published in academic journals. This may be done to enhance the fundamental understanding of nature, without any commercial application or benefit in mind. In the long run, however, basic research is often transformed into applied research with commercial applications. For example, wireless communication technology today is built upon the fundamental science breakthroughs Albert Einstein accomplished over 100 years ago in his research on the nature of light.⁸

In a next step, **invention** describes the transformation of an idea into a new product or process, or the modification and recombination of existing ones. The practical application of basic knowledge in a particular area frequently results in new technology. If an invention is *useful*, *novel*, and *non-obvious* as assessed by the U.S. Patent and Trademark Office, it

invention The transformation of an idea into a new product or process, or the modification and recombination of existing ones.

EXHIBIT 7.2 /

The Four I's: Idea, Invention, Innovation, and Imitation



can be patented.⁹ A **patent** is a form of *intellectual property*, and gives the inventor exclusive rights to benefit from commercializing a technology for a specified time period in exchange for public disclosure of the underlying idea (see also the discussion on *isolating mechanisms* in Chapter 4). In the United States, the time period for the right to exclude others from the use of the technology is 20 years from the filing date of a patent application. Exclusive rights often translate into a *temporary monopoly position* until the patent expires. For instance, many pharmaceutical drugs are patent protected.

Strategically, however, patents are a *double-edged sword*. On the one hand, patents provide a temporary monopoly as they bestow exclusive rights on the patent owner to use a novel technology for a specific time period. Thus, patents may form the basis for a competitive advantage. Because patents require full disclosure of the underlying technology and know-how so that others can use it freely once the patent protection has expired, many firms find it strategically beneficial *not* to patent their technology. Instead they use **trade secrets**, defined as valuable proprietary information that is not in the public domain and where the firm makes every effort to maintain its secrecy. The most famous example of a trade secret is the Coca-Cola recipe, which has been protected for over a century.¹⁰ The same goes for Ferrero's Nutella, whose secret recipe is said to be known by even fewer than the handful of people who have access to the Coca-Cola recipe.¹¹

Avoiding public disclosure and thus making its underlying technology widely known is precisely the reason Netflix does not patent its recommendation algorithm or Google its PageRank algorithm. Netflix has an advantage over competitors because its recommendation algorithm works best; the same goes for Google—its search algorithm is the best available. Disclosing how exactly these algorithms work would nullify their advantage.

Innovation concerns the *commercialization* of an invention.¹² The successful commercialization of a new product or service allows a firm to extract temporary monopoly profits. As detailed in the ChapterCase, Netflix began its life with a business model innovation, offering unlimited DVD rentals via the internet, without any late fees. However, Netflix gained its early lead by applying big data analytics to its user preferences to not only predict future demand but also to provide highly personalized viewing recommendations. The success of the latter is evident by the fact that movies that were recommended to viewers scored higher than they were scored previously. To sustain a competitive advantage, however, a firm must continuously innovate—that is, it must produce a string of successful new products or services over time. In this spirit, Netflix further developed its business model innovation, moving from online DVD rentals to directly streaming content via the internet. Moreover, it innovated further in creating proprietary content such as *House of Cards* and *Orange Is the New Black*.

patent A form of *intellectual property* that gives the inventor exclusive rights to benefit from commercializing a technology for a specified time period in exchange for public disclosure of the underlying idea.

trade secret Valuable proprietary information that is not in the public domain and where the firm makes every effort to maintain its secrecy.

innovation The commercialization of any new product or process, or the modification and recombination of existing ones.

first-mover advantages

Competitive benefits
that accrue to the
successful innovator.

Successful innovators can benefit from a number of **first-mover advantages**,¹³ including economies of scale as well as experience and learning-curve effects (as discussed in Chapter 6). First movers may also benefit from *network effects* (see the discussion of Apple and Uber later in this chapter). Moreover, first movers may hold important intellectual property such as critical patents. They may also be able to lock in key suppliers as well as customers through increasing switching costs. For example, users of Microsoft Word might find the switching costs entailed in moving to a different word-processing software prohibitive. Not only would they need to spend many hours learning the new software, but collaborators would also need to have compatible software installed and be familiar with the program to open and revise shared documents.

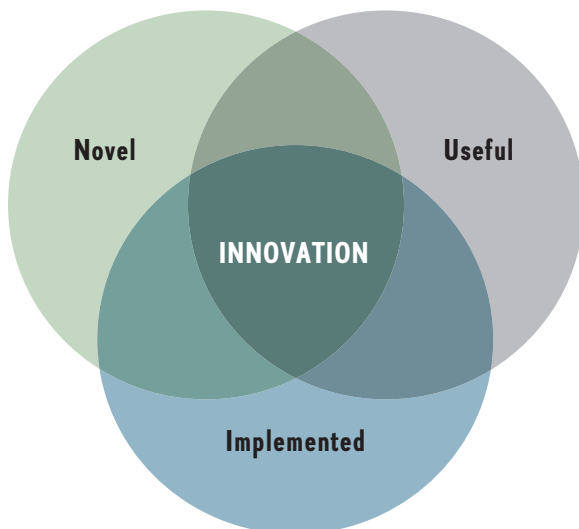
Google—by offering a free web-based suite of application software such as word-processing (Google Docs), spreadsheet (Google Sheets), and presentation programs (Google Slides)—is attempting to minimize switching costs by leveraging *cloud computing*—a real-time network of shared computing resources via the internet (Google Drive). Rather than requiring each user to have the appropriate software installed on his or her personal computer, the software is maintained and updated in the cloud. Files are also saved in the cloud, which allows collaboration in real time globally wherever one can access an internet connection.

Innovation need not be high-tech to be a potent competitive weapon, as P&G's history of innovative product launches such as the Swiffer line of cleaning products shows. P&G uses the *razor-razor-blade business model* (introduced in Chapter 5), where the consumer purchases the handle at a low price, but must pay a premium for replacement refills and pads over time. As shown in Exhibit 7.3, an innovation needs to be novel, useful, and successfully implemented to help firms gain and sustain a competitive advantage.

The innovation process ends with *imitation*. If an innovation is successful in the marketplace, competitors will attempt to imitate it. Although Netflix has some 50 million U.S. subscribers, imitators are set to compete its advantage away. Amazon offers its Instant Video service to its estimated 65 million Prime subscribers (\$99 a year or \$8.25 a month), with selected titles free. In addition, Prime members receive free two-day shipping on Amazon purchases.

Hulu Plus (\$7.99 a month), a video-on-demand service, has some 9 million subscribers. One advantage Hulu Plus has over Netflix and Amazon is that it typically makes the latest episodes of popular TV shows available the day following broadcast, on Hulu; the shows are often delayed by several months before being offered by Netflix or Amazon. A joint venture of NBCUniversal Television Group (Comcast), Fox Broadcasting (21st Century Fox), and Disney/ABC Television Group (The Walt Disney Co.), Hulu Plus uses advertisements along with its subscription fees as revenue sources. Finally, Google's YouTube with its more than 1 billion users is evolving into a TV ecosystem, benefiting not only from free content uploaded by its users but also creating original programming. As of 2017, the most subscribed channels were by PewDiePie (57 million) and YouTube Spotlight, its official channel (26 million) used to highlight videos and events such as YouTube Music Awards and YouTube Comedy Week¹⁴. Google's business is, of course, ad supported. Only time will tell whether Netflix will be able to sustain its competitive advantage given the imitation attempts by a number of potent competitors.

EXHIBIT 7.3 / Innovation: A Novel and Useful Idea That Is Successfully Implemented



7.2 Strategic and Social Entrepreneurship

Entrepreneurship describes the process by which change agents (entrepreneurs) undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.¹⁵ Entrepreneurs innovate by commercializing ideas and inventions.¹⁶ They seek out or create new business opportunities and then assemble the resources necessary to exploit them.¹⁷ Indeed, innovation is the competitive weapon entrepreneurs use to exploit opportunities created by change, or to create change themselves, in order to commercialize new products, services, or business models.¹⁸ If successful, entrepreneurship not only drives the competitive process, but it also creates value for the individual entrepreneurs and society at large.

Although many new ventures fail, some achieve spectacular success. Examples of successful entrepreneurs are:

- **Reed Hastings**, founder of Netflix featured in the ChapterCase. Hastings grew up in Cambridge, Massachusetts. He obtained an undergraduate degree in math and then volunteered for the Peace Corps for two years, teaching high school math in Swaziland (Africa). Next, he pursued a master's degree in computer science, which brought him to Silicon Valley. Hastings declared his love affair with writing computer code, but emphasized, “The big thing that Stanford did for me was to turn me on to the entrepreneurial model.”¹⁹ His net worth today is an estimated \$1 billion.
- **Dr. Dre**, featured in ChapterCase 4, a successful rapper, music and movie producer, and serial entrepreneur. Born in Compton, California, Dr. Dre focused on music and entertainment early on during high school, working his first job as a DJ. Dr. Dre's major breakthrough as a rapper came with the group N.W.A. One of his first business successes as an entrepreneur was Death Row Records, which he founded in 1991. A year later, Dr. Dre's first solo album, *The Chronic*, was a huge hit. In 1996, Dr. Dre founded Aftermath Entertainment and signed famed rappers such as 50 Cent and Eminem. Dr. Dre, known for his strong work ethic and attention to detail, expects nothing less than perfection from the people with whom he works. Stories abound that Dr. Dre made famous rappers rerecord songs hundreds of times if he was not satisfied with the outcome. In 2014, Dr. Dre appeared to become the first hip-hop billionaire after Apple acquired Beats Electronics for \$3 billion. In 2015, N.W.A.'s early success was depicted in the biographical movie *Straight Outta Compton*, focusing on group members Eazy-E, Ice Cube, and Dr. Dre, who coproduced the film, grossing over \$200 million at the box office, with a budget of \$45 million.²⁰
- **Jeff Bezos**, the founder of Amazon.com (featured in ChapterCase 8), the world's largest online retailer. The stepson of a Cuban immigrant, Bezos graduated with a degree in computer science and electrical engineering, before working as a financial analyst on Wall Street. In 1994, after reading that the internet was growing by 2,000 percent a month, he set out to leverage the internet as a new distribution channel. Listing products that could be sold online, he finally settled on books because that retail market was fairly fragmented, with huge inefficiencies in its distribution system. Perhaps even more important, books are a perfect commodity because they are identical regardless of where a consumer buys them. This reduced uncertainty when introducing online shopping to consumers. In 2017 his personal wealth exceeded \$80 billion.²¹
- **Elon Musk**, an engineer and serial entrepreneur with a deep passion to “solve environmental, social, and economic challenges.”²² We featured him in his role as leader of Tesla in ChapterCase 1. Musk left his native South Africa at age 17. He went to Canada and then to the United States, where he completed a bachelor's degree in economics and physics at the University of Pennsylvania. After only two days in a PhD program in

LO 7-2

Apply strategic management concepts to entrepreneurship and innovation.

entrepreneurship The process by which people undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.



Dr. Dre, rapper, music and movie producer, as well as highly successful serial entrepreneur.

©JC Olivera/Getty Images
Entertainment/Getty Images

applied physics and material sciences at Stanford University, Musk left graduate school to found Zip2, an online provider of content publishing software for news organizations. Four years later, in 1999, computer maker Compaq acquired Zip2 for \$341 million (and was in turn acquired by HP in 2002). Musk moved on to co-found PayPal, an online payment processor. When eBay acquired PayPal for \$1.5 billion in 2002, Musk had the financial resources to pursue his passion to use science and engineering to solve social and economic challenges. He is leading three new ventures simultaneously: electric cars with Tesla, renewable energy with SolarCity, and space exploration with SpaceX.²³ (In 2016, Tesla Motors acquired SolarCity, renaming itself simply Tesla).

entrepreneurs

The agents that introduce change into the competitive system.

Entrepreneurs are the agents who introduce change into the competitive system. They do this not only by figuring out how to use inventions, but also by introducing new products or services, new production processes, and new forms of organization. Entrepreneurs can introduce change by starting new ventures, such as Reed Hastings with Netflix or Mark Zuckerberg with Facebook. Or they can be found within existing firms, such as A.G. Lafley at Procter & Gamble (P&G), who implemented an *open-innovation model* (which we'll discuss in Chapter 11). When innovating within existing companies, change agents are often called *intrapreneurs*: those pursuing *corporate entrepreneurship*.²⁴

Entrepreneurs who drive innovation need just as much skill, commitment, and daring as the inventors who are responsible for the process of invention.²⁵ As an example, the engineer Nikola Tesla invented the alternating-current (AC) electric motor and was granted a patent in 1888 by the U.S. Patent and Trademark Office.²⁶ Because this breakthrough technology was neglected for much of the 20th century and Nikola Tesla did not receive the recognition he deserved in his lifetime, the entrepreneur Elon Musk is not just commercializing Tesla's invention but also honoring Tesla with the name of his company, Tesla, which was formed to design and manufacture all-electric automobiles. Tesla launched several all-electric vehicles based on Tesla's original invention (see ChapterCase 1).

strategic

entrepreneurship

The pursuit of innovation using tools and concepts from strategic management.

Strategic entrepreneurship describes the pursuit of innovation using tools and concepts from strategic management.²⁷ We can leverage innovation for competitive advantage by applying a strategic management lens to entrepreneurship. The fundamental question of strategic entrepreneurship, therefore, is how to combine entrepreneurial actions, creating new opportunities or exploiting existing ones with strategic actions taken in the pursuit of competitive advantage.²⁸ This can take place within new ventures such as Tesla or within established firms such as Apple. Apple's continued innovation in mobile devices is an example of strategic entrepreneurship: Apple's managers use strategic analysis, formulation, and implementation when deciding which new type of mobile device to research and develop, when to launch it, and how to implement the necessary organizational changes to support the product launch. Each new release is an innovation; each is therefore an act of entrepreneurship—planned and executed using strategic management concepts. In 2015, for example, Apple entered the market for computer wearables by introducing the Apple Watch. In 2017, Apple released the 10th-year anniversary model of its original iPhone, introduced in 2007.

social

entrepreneurship

The pursuit of social goals while creating a profitable business.

Social entrepreneurship describes the pursuit of social goals while creating profitable businesses. Social entrepreneurs evaluate the performance of their ventures not only by financial metrics but also by ecological and social contribution (*profits, planet, and people*). They use a *triple-bottom-line* approach to assess performance (discussed in Chapter 5). Examples of social entrepreneurship ventures include Teach For America, TOMS Shoes (which gives a pair of shoes to an economically disadvantaged child for every pair of shoes it sells), Better World Books (an online bookstore that uses capitalism to alleviate illiteracy around the world),²⁹ and Wikipedia, whose mission is to collect and develop educational information, and make it freely available to any person in the world (see following and MiniCase 14).

The founder of Wikipedia, Jimmy Wales, typifies social entrepreneurship.³⁰ Raised in Alabama, Wales was educated by his mother and grandmother who ran a nontraditional school. In 1994, he dropped out of a doctoral program in economics at Indiana University to take a job at a stock brokerage firm in Chicago. In the evenings he wrote computer code for fun and built a web browser. During the late 1990s internet boom, Wales was one of the first to grasp the power of an open-source method to provide knowledge on a very large scale. What differentiates Wales from other web entrepreneurs is his idealism: Wikipedia is free for the end user and supports itself solely by donations and not, for example, by online advertising. Wikipedia has 35 million articles in 288 languages, including some 5 million items in English. About 500 million people use Wikipedia each month. Wales' idealism is a form of social entrepreneurship: His vision is to make the entire repository of human knowledge available to anyone anywhere for free.

Since entrepreneurs and the innovations they unleash frequently create entire new industries, we now turn to a discussion of the industry life cycle to derive implications for competitive strategy.

7.3 Innovation and the Industry Life Cycle

Innovations frequently lead to the birth of new industries. Innovative advances in IT and logistics facilitated the creation of the overnight express delivery industry by FedEx and that of big-box retailing by Walmart. The internet set online retailing in motion, with new companies such as Amazon and eBay taking the lead, and it revolutionized the advertising industry first through Yahoo, and later Google and Facebook. Advances in nanotechnology are revolutionizing many different industries, ranging from medical diagnostics and surgery to lighter and stronger airplane components.³¹

Industries tend to follow a predictable **industry life cycle**: As an industry evolves over time, we can identify five distinct stages: *introduction*, *growth*, *shakeout*, *maturity*, and *decline*.³² We will illustrate how the type of innovation and resulting strategic implications change at each stage of the life cycle as well as how innovation can initiate and drive a new life cycle.

The number and size of competitors change as the industry life cycle unfolds, and different types of consumers enter the market at each stage. That is, both the supply and demand sides of the market change as the industry ages. Each stage of the industry life cycle requires different competencies for the firm to perform well and to satisfy that stage's unique customer group. We first introduce the life cycle model before discussing different customer groups in more depth when introducing the crossing-the-chasm concept later in this chapter.³³

Exhibit 7.4 depicts a typical industry life cycle, focusing on the smartphone industry in emerging and developed economies. In a stylized industry life cycle model, the horizontal axis shows time (in years) and the vertical axis market size. In Exhibit 7.4, however, we are taking a snapshot of the global smartphone industry in the year 2018. This implies that we are joining two different life cycles (one for emerging economies and one for developed economies) in the same exhibit at one point in time.

The development of most industries follows an S-curve. Initial demand for a new product or service is often slow to take off, then accelerates, before decelerating, and eventually turning to zero, and even becoming negative as a market contracts.

As shown in Exhibit 7.4, in emerging economies such as Argentina, Brazil, China, India, Indonesia, Mexico, and Russia, the smartphone industry is in the growth stage. The market for smartphones in these countries is expected to grow rapidly over the next few years. More and more of the consumers in these countries with very large populations

LO 7-3

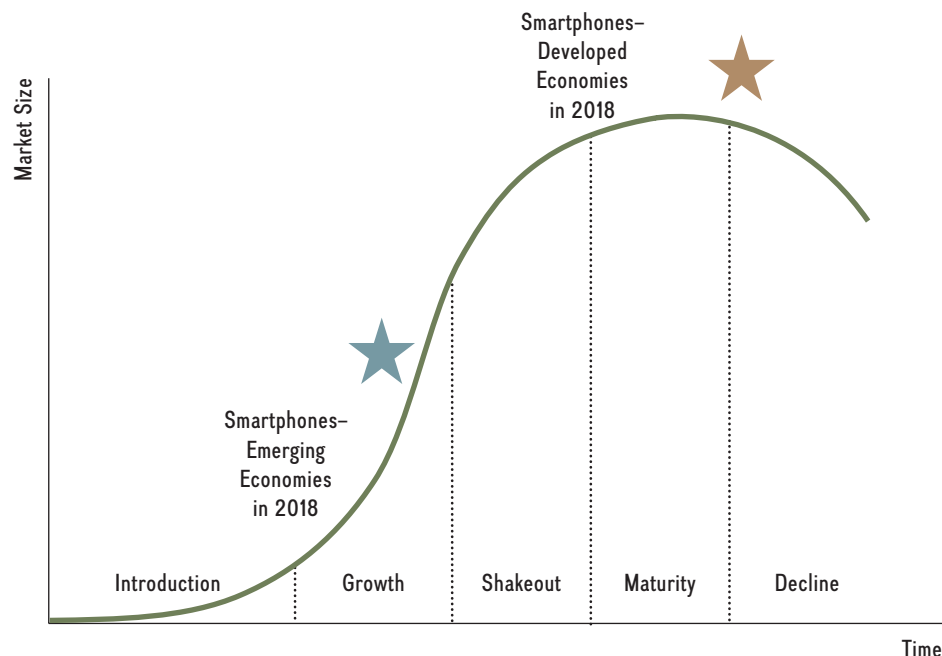
Describe the competitive implications of different stages in the industry life cycle.

industry life cycle

The five different stages—introduction, growth, shakeout, maturity, and decline—that occur in the evolution of an industry over time.

EXHIBIT 7.4 /

Industry Life Cycle:
The Smartphone
Industry in Emerging
and Developed
Economies



are expected to upgrade from a simple mobile phone to a smartphone such as the Apple iPhone, Samsung Galaxy, or Xiaomi's popular Mi6.

In contrast, the market for smartphones is in the maturity stage in 2018 in developed economies such as Australia, Canada, Germany, Japan, South Korea, the United Kingdom, and the United States. This implies that developed economies moved through the prior three stages of the industry life cycle (introductory, growth, and shakeout) some years earlier. Because the smartphone industry is mature in these markets, little or no growth in market size is expected over the next few years because most consumers own smartphones. This implies that any market share gain by one firm comes at the expense of others, as users replace older smartphones with newer models. Competitive intensity is expected to be high.

Each stage of the industry life cycle—introduction, growth, shakeout, maturity, and decline—has different strategic implications for competing firms. We now discuss each stage in detail.

INTRODUCTION STAGE

When an individual inventor or company launches a successful innovation, a new industry may emerge. In this introductory stage, the innovator's core competency is R&D, which is necessary to creating a product category that will attract customers. This is a capital-intensive process, in which the innovator is investing in designing a unique product, trying new ideas to attract customers, and producing small quantities—all of which contribute to a high price when the product is launched. The initial market size is small, and growth is slow.

In this introductory stage, when barriers to entry tend to be high, generally only a few firms are active in the market. In their competitive struggle for market share, they emphasize unique product features and performance rather than price.

Although there are some benefits to being early in the market (as previously discussed), innovators also may encounter *first-mover disadvantages*. They must educate potential

customers about the product's intended benefits, find distribution channels and complementary assets, and continue to perfect the fledgling product. Although a core competency in R&D is necessary to create or enter an industry in the introductory stage, some competency in marketing also is helpful in achieving a successful product launch and market acceptance. Competition can be intense, and early winners are well-positioned to stake out a strong position for the future. As one of the main innovators in software for mobile devices, Google's Android operating system for smartphones is enjoying a strong market position and substantial lead over competitors.

The strategic objective during the introductory stage is to achieve market acceptance and seed future growth. One way to accomplish these objectives is to initiate and leverage **network effects**,³⁴ the positive effect that one user of a product or service has on the value of that product for other users. Network effects occur when the value of a product or service increases, often exponentially, with the number of users. If successful, network effects propel the industry to the next stage of the life cycle, the growth stage (which we discuss next).

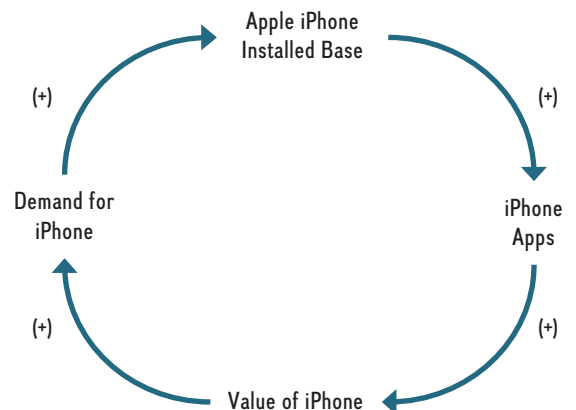
Apple effectively leveraged the network effects generated by numerous complementary software applications (apps) available via iTunes to create a tightly integrated ecosystem of hardware, software, and services, which competitors find hard to crack. The consequence has been a competitive advantage for over a decade, beginning with the introduction of the iPod in 2001 and iTunes in 2003. Apple launched its enormously successful iPhone in the summer of 2007. A year later, it followed up with the Apple App Store, which boasts, for almost anything you might need, "there's an app for that." Popular apps allow iPhone users to access their business contacts via LinkedIn, hail a ride via Uber, call colleagues overseas via Skype, check delivery of their Zappos packages shipped via UPS, get the latest news on Twitter, and engage in customer relationship management using Salesforce.com. You can stream music via Pandora, post photos using Instagram, watch Netflix, access Facebook to check on your friends, or video message using Snap.

Even more important is the effect that apps have on the value of an iPhone. Arguably, the explosive growth of the iPhone is due to the fact that the Apple App Store offers the largest selection of apps to its users. By 2017, the App Store offered more than 2 million apps, which had been downloaded more than 130 billion times, earning Apple some \$50 billion in revenues. Moreover, Apple argues that users have a better experience because the apps take advantage of the tight integration of hardware and software provided by the iPhone. The availability of apps, in turn, leads to network effects that increase the value of the iPhone for its users. Exhibit 7.5 shows how. Increased value creation, as we know from Chapter 6, is positively related to demand, which in turn increases the installed base, meaning the number of people using an iPhone. As of the spring of 2017, Apple had sold some 80 million iPhone 7 models in just six months. The average selling price of an iPhone was \$700; with the latest model (iPhone X) priced at \$1,000. As the installed base of iPhone users further increases, this incentivizes software developers to write even more apps. Making apps widely available strengthened Apple's position in the smartphone industry. Based on positive feedback loops, a virtuous cycle emerges where one factor positively reinforces another. Apple's ecosystem based on integrated hardware, software, and services providing a superior user experience is hard to crack for competitors.

network effects

The positive effect (externality) that one user of a product or service has on the value of that product for other users.

EXHIBIT 7.5 / Leveraging Network Effects to Drive Demand: Apple's iPhone



GROWTH STAGE

Market growth accelerates in the growth stage of the industry life cycle (see Exhibit 7.4). After the initial innovation has gained some market acceptance, demand increases rapidly as first-time buyers rush to enter the market, convinced by the proof of concept demonstrated in the introductory stage.

As the size of the market expands, a **standard** signals the market's agreement on a common set of engineering features and design choices.³⁵ Standards can emerge from the bottom up through competition in the marketplace or be imposed from the top down by government or other standard-setting agencies such as the Institute of Electrical and Electronics Engineers (IEEE) that develops and sets industrial standards in a broad range of industries, including energy, electric power, biomedical and health care technology, IT, telecommunications, consumer electronics, aerospace, and nanotechnology. Strategy Highlight 7.1 discusses the unfolding standards battle in the automotive industry.

standard

An agreed-upon solution about a common set of engineering features and design choices.

Strategy Highlight 7.1

Standards Battle: Which Automotive Technology Will Win?

In the envisioned future transition away from gasoline-powered cars, Nissan Chairman Carlos Ghosn firmly believes the next technological paradigm will be electric motors. Ghosn calls hybrids a “halfway technology” and suggests they will be a temporary phenomenon at best. A number of start-up companies, including Tesla in the United States and BYD Auto in China, share Ghosn's belief in this particular future scenario.

One of the biggest impediments to large-scale adoption of electric vehicles, however, remains the lack of appropriate infrastructure: There are few stations where drivers can recharge their car's battery when necessary. With the range of electric vehicles currently limited to some 200 miles, many consider a lack of recharging stations a serious problem, so called “range anxiety.” High-end Tesla vehicles can achieve 250 miles per charge, while a lower priced Nissan Leaf's maximum range is roughly 85 miles. Tesla, Nissan, and other independent charging providers such as ChargePoint, however, are working hard to develop a network of charging stations. By early 2017, Tesla claimed a network of some 800 supercharger stations throughout the United States and was building more stalls at many stations. It also enabled the in-car map to identify how many stalls were open at each station in real time.

Nissan's Ghosn believes electric cars will account for up to 10 percent of global auto sales over the next decade. The



The Nissan Leaf, the world's best-selling electric vehicle.
©VDWI Automotive/Alamy Stock Photo RF

Swedish car maker Volvo has gone even further by announcing that beginning in 2019 it will no longer produce any cars with internal combustion engines. Rather, all its new vehicles will be fully electric or hybrid. This is a strong strategic commitment by one of the traditional car manufacturers. It is also the first of its kind.

In contrast, Toyota is convinced gasoline-electric hybrids will become the next dominant technology. These different predictions have significant influence on how much money Nissan and Toyota invest in technology and where. Nissan builds one of its fully electric vehicles, the Leaf (an acronym for Leading, Environmentally friendly, Affordable, Family car) at a plant in Smyrna, Tennessee. Toyota is expanding

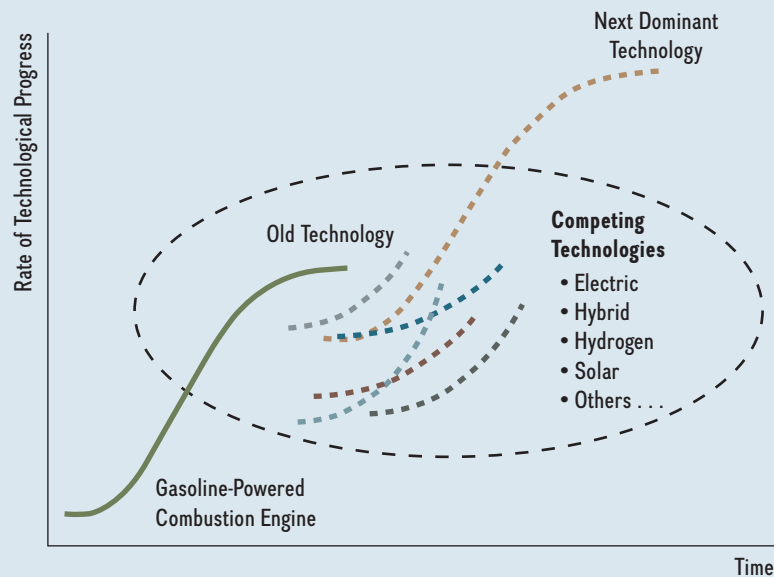
its R&D investments in hybrid technology. Nissan put its money where its mouth is and has spent millions developing its electric-car program since the late 1990s. Since it was introduced in December 2010, the Nissan Leaf has become the best-selling electric vehicle, with more than 250,000 units sold. The most recent Nissan Leaf model has a range of more than 100 miles per charge. In 2017, GM introduced the all-electric Chevy Bolt, with a range of over 200 miles per charge, similar to Tesla's Model 3.

Toyota, on the other hand, has already sold 10 million of its popular Prius cars since they were introduced in 1997. By 2020, Toyota plans to offer hybrid technology in all its

vehicles. Eventually, the investments made by Nissan and Toyota will yield different returns, depending on which predictions prove more accurate.

An alternative outcome is that neither hybrids nor electric cars will become the next paradigm. To add even more uncertainty to the mix, Honda and BMW are betting on cars powered by hydrogen fuel cells. In sum, many alternative technologies are competing to become the winner in setting a new standard for propelling cars. This situation is depicted in Exhibit 7.6, where the new technologies represent a swarm of new entries vying for dominance. Only time will tell which technology will win this standards battle.³⁶

EXHIBIT 7.6 Automotive Technologies Compete for Industry Dominance



Since demand is strong during the growth phase, both efficient and inefficient firms thrive; the rising tide lifts all boats. Moreover, prices begin to fall, often rapidly, as standard business processes are put in place and firms begin to reap economies of scale and learning. Distribution channels are expanded, and complementary assets in the form of products and services become widely available.³⁷

After a standard is established in an industry, the basis of competition tends to move away from product innovations toward process innovations.³⁸ **Product innovations**, as the name suggests, are new or recombined knowledge embodied in new products—the jet airplane, electric vehicle, smartphones, and wearable computers. **Process innovations** are new ways to produce existing products or to deliver existing services. Process innovations are made possible through advances such as the internet, lean manufacturing, Six Sigma, biotechnology, nanotechnology, and so on.

product innovation
New or recombined knowledge embodied in new products.

process innovation
New ways to produce existing products or deliver existing services.

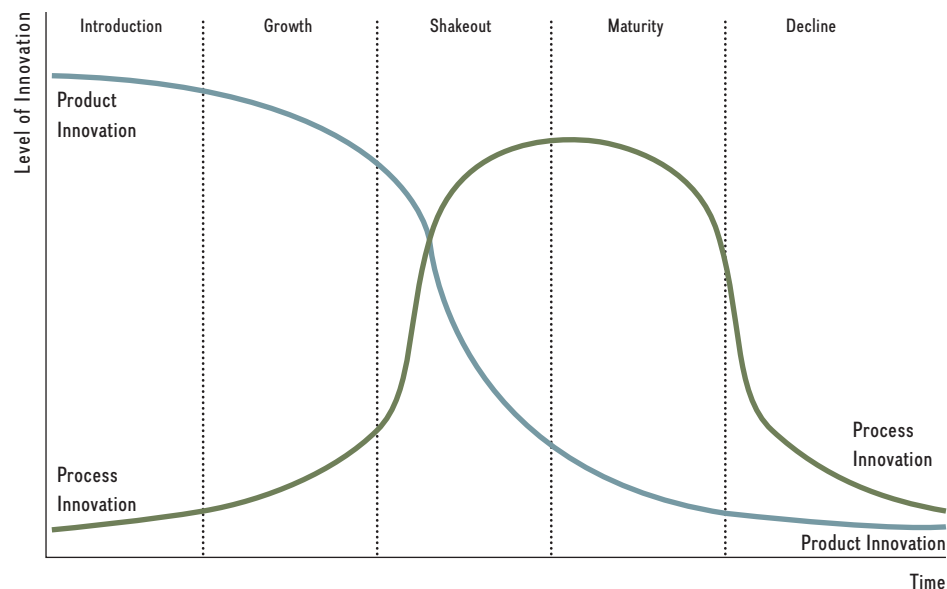
Process innovation must not be high-tech to be impactful, however. The invention of the standardized shipping container, for instance, has transformed global trade. By loading goods into uniform containers that could easily be moved between trucks, rail, and ships, significant savings in cost and time were accomplished. Before containerization was invented some 60 years ago, it cost almost \$6 to load a ton of (loose) cargo, and theft was rampant. After containerization, the cost for loading a ton of cargo had plummeted to \$0.16 and theft all but disappeared (because containers are sealed at the departing factory). Efficiency gains in terms of labor and time were even more impressive. Before containerization, dock labor could move 1.7 tons per hour onto a cargo ship. After containerization, this had jumped to 30 tons per hour. Ports are now able to accommodate much larger ships, and travel time across the oceans has fallen in half. As a consequence, costs for shipping goods across the globe have fallen rapidly. Moreover, containerization enabled optimization of global supply chains and set the stage for subsequent process innovations such as *just-in-time (JIT) operations management*. Taken together, a set of research studies estimated that containerization alone more than tripled international trade within five years of adopting this critical process innovation.³⁹

Exhibit 7.7 shows the level of product and process innovation throughout the entire life cycle.⁴⁰ In the introductory stage, the level of *product* innovation is at a maximum because new features increasing perceived consumer value are critical to gaining traction in the market. In contrast, process innovation is at a minimum in the introductory stage because companies produce only a small number of products, often just prototypes or beta versions. The main concern is to commercialize the invention—that is, to demonstrate that the product works and that a market exists.

The relative importance, however, reverses over time. Frequently, a standard emerges during the growth stage of the industry life cycle (see the second column, “Growth,” in Exhibit 7.7). At that point, most of the technological and commercial uncertainties about the new product are gone. After the market accepts a new product, and a standard for the new technology has emerged, *process* innovation rapidly becomes more important than product innovation. As market demand increases, economies of scale kick in: Firms establish and optimize standard business processes through applications of lean manufacturing,

EXHIBIT 7.7

Product and Process Innovation throughout an Industry Life Cycle



Six Sigma, and so on. As a consequence, product improvements become incremental, while the level of process innovation rises rapidly.

During the growth stage, process innovation ramps up (at increasing marginal returns) as firms attempt to keep up with rapidly rising demand while attempting to bring down costs at the same time. The core competencies for competitive advantage in the growth stage tend to shift toward manufacturing and marketing capabilities. At the same time, the R&D emphasis tends to shift to process innovation for improved efficiency. Competitive rivalry is somewhat muted because the market is growing fast.

Since market demand is robust in this stage and more competitors have entered the market, there tends to be more strategic variety: Some competitors will continue to follow a *differentiation* strategy, emphasizing unique features, product functionality, and reliability. Other firms employ a *cost-leadership strategy* in order to offer an acceptable level of value but lower prices to consumers. They realize that lower cost is likely a key success factor in the future, because this will allow the firm to lower prices and attract more consumers into the market. When introduced in the spring of 2010, for example, Apple's first-generation iPad was priced at \$829 for 64GB with a 3G Wi-Fi connection.⁴¹ Just three years later, in spring 2013, the same model was priced at only one-third of the original price, or \$275.⁴² Access to efficient and large-scale manufacturing operations (such as those offered by Foxconn in China, the company that assembles most of Apple's products) and effective supply chain capabilities are key success factors when market demand increases rapidly. By 2017, Gazelle, an ecommerce company that allows people to sell their electronic devices and to buy pre-certified used ones, offered a mere \$15 for a "flawless" first-generation iPad.

The key objective for firms during the growth phase is to stake out a strong strategic position not easily imitated by rivals. In the fast-growing shapewear industry, start-up company Spanx has staked out a strong position. In 1998, Florida State University graduate Sara Blakely decided to cut the feet off her pantyhose to enhance her looks when wearing pants.⁴³ Soon after she obtained a patent for her body-shaping undergarments, and Spanx began production and retailing of its shapewear in 2000. Sales grew exponentially after Blakely appeared on *The Oprah Winfrey Show*. By 2017, Spanx had grown to more than 250 employees and sold millions of Spanx "power panties," with estimated revenues of some \$500 million. To stake out a strong position and to preempt competitors, Spanx now offers over 200 products ranging from slimming apparel and swimsuits to bras and activewear. Moreover, it now designs and manufactures body-shaping undergarments for men ("Spanx for Men—Manx"). Spanx products are now available in over 50 countries globally via the internet. Moreover, to strengthen its strategic position and brand image in the United States, Spanx is opening retail stores across the country.

The shapewear industry's explosive growth—it is expected to reach \$6 billion in annual sales by 2022—has attracted several other players: Flexees by Maidenform, BodyWrap, and Miraclesuit, to name a few. They are all attempting to carve out positions in the new industry. Given Spanx's ability to stake out a strong position during the growth stage of the industry life cycle and the fact that it continues to be a moving target, it might be difficult for competitors to dislodge the company.

Taking the risk paid off for Spanx's founder: After investing an initial \$5,000 into her startup, Blakely became the world's youngest self-made female billionaire. Blakely was also listed in the Time 100, the annual list of the most influential people in the world.

SHAKEOUT STAGE

Rapid industry growth and expansion cannot go on indefinitely. As the industry moves into the next stage of the industry life cycle, the rate of growth declines (see Exhibit 7.4). Firms begin to compete directly against one another for market share, rather than trying

to capture a share of an increasing pie. As competitive intensity increases, the weaker firms are forced out of the industry. This is the reason this phase of the industry life cycle is called the shakeout stage: Only the strongest competitors survive increasing rivalry as firms begin to cut prices and offer more services, all in an attempt to gain more of a market that grows slowly, if at all. This type of cutthroat competition erodes profitability of all but the most efficient firms in the industry. As a consequence, the industry often consolidates, as the weakest competitors either are acquired by stronger firms or exit through bankruptcy.

The winners in this increasingly competitive environment are often firms that stake out a strong position as cost leaders. Key success factors at this stage are the manufacturing and process engineering capabilities that can be used to drive costs down. The importance of process innovation further increases (albeit at diminishing marginal returns), while the importance of product innovation further declines.

Assuming an acceptable value proposition, price becomes a more important competitive weapon in the shakeout stage, because product features and performance requirements tend to be well-established. A few firms may be able to implement a blue ocean strategy, combining differentiation and low cost, but given the intensity of competition, many weaker firms are forced to exit. Any firm that does not have a clear strategic profile is likely to not survive the shakeout phase.

MATURITY STAGE

After the shakeout is completed and a few firms remain, the industry enters the maturity stage. During the fourth stage of the industry life cycle, the industry structure morphs into an oligopoly with only a few large firms. Most of the demand was largely satisfied in the shakeout stage. Any additional market demand in the maturity stage is limited. Demand now consists of replacement or repeat purchases. The market has reached its maximum size, and industry growth is likely to be zero or even negative going forward. This decrease in market demand increases competitive intensity within the industry. In the maturity stage, the level of process innovation reaches its maximum as firms attempt to lower cost as much as possible, while the level of incremental product innovation sinks to its minimum (see Exhibit 7.7).

Generally, the firms that survive the shakeout stage tend to be larger and enjoy economies of scale, as the industry consolidated and most excess capacity was removed. The domestic airline industry has been in the maturity stage for a long time. The large number of bankruptcies as well as the wave of mega-mergers, such as those of Delta and Northwest, United and Continental, and American Airlines and US Airways, are a consequence of low or zero growth in a mature market characterized by significant excess capacity.

DECLINE STAGE

Changes in the external environment (such as those discussed in Chapter 3 when presenting the PESTEL framework) often take industries from maturity to decline. In this final stage of the industry life cycle, the size of the market contracts further as demand falls, often rapidly. At this final phase of the industry life cycle, innovation efforts along both product and process dimensions cease (see Exhibit 7.7). If a technological or business model breakthrough emerges that opens up a *new* industry, however, then this dynamic interplay between product and process innovation starts anew.

If there is any remaining excess industry capacity in the decline stage, this puts strong pressure on prices and can further increase competitive intensity, especially if the industry

has high exit barriers. At this final stage of the industry life cycle, managers generally have four strategic options: *exit*, *harvest*, *maintain*, or *consolidate*.⁴⁴

- **Exit.** Some firms are forced to *exit* the industry by bankruptcy or liquidation. The U.S. textile industry has experienced a large number of exits over the last few decades, mainly due to low-cost foreign competition.
- **Harvest.** In pursuing a *harvest strategy*, the firm reduces investments in product support and allocates only a minimum of human and other resources. While several companies such as IBM, Brother, Olivetti, and Nakajima still offer typewriters, they don't invest much in future innovation. Instead, they are maximizing cash flow from their existing typewriter product line.
- **Maintain.** Philip Morris, on the other hand, is following a *maintain strategy* with its Marlboro brand, continuing to support marketing efforts at a given level despite the fact that U.S. cigarette consumption has been declining.
- **Consolidate.** Although market size shrinks in a declining industry, some firms may choose to *consolidate* the industry by buying rivals. This allows the consolidating firm to stake out a strong position—possibly approaching monopolistic market power, albeit in a declining industry.

Although chewing tobacco is a declining industry, Swedish Match has pursued a number of acquisitions to consolidate its strategic position in the industry. It acquired, among other firms, the Pinkerton Tobacco Co. of Owensboro, Kentucky, maker of the Red Man brand. Red Man is the leading chewing tobacco brand in the United States. Red Man has carved out a strong strategic position built on a superior reputation for a quality product and by past endorsements of Major League Baseball players since 1904. Despite gory product warnings detailing the health risk of chewing tobacco and a federally mandated prohibition on marketing, the Red Man brand has remained not only popular, but also profitable.

The industry life cycle model assumes a more or less smooth transition from one stage to another. This holds true for most continuous innovations that require little or no change in consumer behavior. But not all innovations enjoy such continuity.

CROSSING THE CHASM

In the influential bestseller *Crossing the Chasm*⁴⁵ Geoffrey Moore documented that many innovators were unable to successfully transition from one *stage of the industry life cycle* to the next. Based on empirical observations, Moore's core argument is that *each stage of the industry life cycle is dominated by a different customer group*. Different customer groups with distinctly different preferences enter the industry at each stage of the industry life cycle. Each customer group responds differently to a technological innovation. This is due to differences in the psychological, demographic, and social attributes observed in each unique customer segment. Moore's main contribution is that the significant differences between the *early* customer groups—who enter during the introductory stage of the industry life cycle—and *later* customers—who enter during the growth stage—can make for a difficult transition between the different parts of the industry life cycle. Such differences between customer groups lead to a big gulf or *chasm* into which companies and their innovations frequently fall. Only companies that recognize these differences and are able to apply the appropriate competencies at each stage of the industry life cycle will have a chance to transition successfully from stage to stage.

Exhibit 7.8 shows the **crossing-the-chasm framework** and the different customer segments. The industry life cycle model (shown in Exhibit 7.4) follows an S-curve leading

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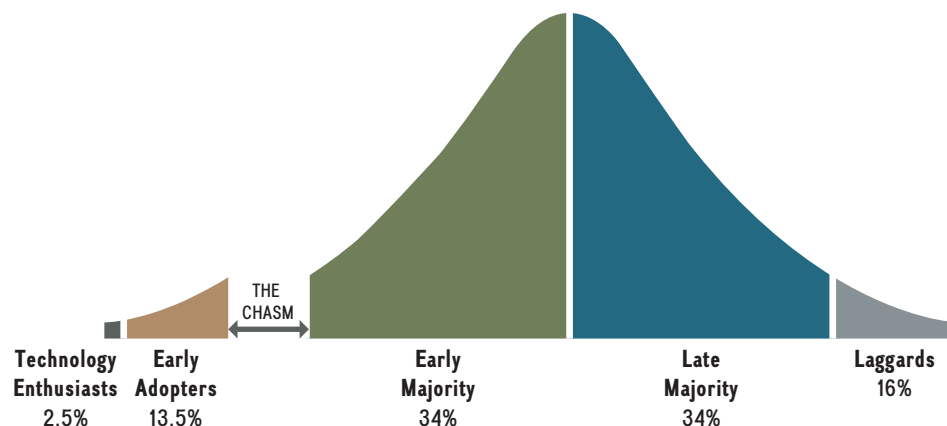
Derive strategic implications of the crossing-the-chasm framework.

crossing-the-chasm framework Conceptual model that shows how each stage of the industry life cycle is dominated by a different customer group.

EXHIBIT 7.8

The Crossing-the-Chasm Framework

SOURCE: Adapted from G.A. Moore (1991), *Crossing the Chasm: Marketing and Selling Disruptive Products to Mainstream Customers* (New York: HarperCollins), 17.



up to 100 percent total market potential that can be reached during the maturity stage. In contrast, the *chasm framework* breaks down the 100 percent market potential into different customer segments, highlighting the *incremental* contribution each specific segment can bring into the market. This results in the familiar bell curve. Note the big gulf, or *chasm*, separating the early adopters from the early and late majority that make up the mass market. Social network sites have followed a pattern similar to that illustrated in Exhibit 7.8. Friendster was unable to cross the big chasm. Myspace was successful with the early majority, but only Facebook went on to succeed with the late majority and laggards. Each stage customer segment, moreover, is also separated by smaller chasms. Both the large competitive chasm and the smaller ones have strategic implications.

Both new technology ventures and innovations introduced by established firms have a high failure rate. This can be explained as a failure to successfully cross the chasm from the early users to the mass market because the firm does not recognize that the business strategy needs to be fine-tuned for each customer segment. Formulating a business strategy for each segment guided by the *who, what, why, and how* questions of competition (Who to serve? What needs to satisfy? Why and how to satisfy them?), introduced in Chapter 6, the firm will find that the core competencies to satisfy each of the different customer segments are quite different. If not recognized and addressed, this will lead to the demise of the innovation as it crashes into the chasm between life cycle stages.

We first introduce each customer group and map it to the respective stage of the industry life cycle. To illustrate, we then apply the chasm framework to an analysis of the mobile phone industry.

TECHNOLOGY ENTHUSIASTS. The customer segment in the introductory stage of the industry life cycle is called *technology enthusiasts*.⁴⁶ The smallest market segment, it makes up some 2.5 percent of total market potential. Technology enthusiasts often have an engineering mind-set and pursue new technology proactively. They frequently seek out new products before the products are officially introduced into the market. Technology enthusiasts enjoy using beta versions of products, tinkering with the product's imperfections and providing (free) feedback and suggestions to companies. For example, many software companies such as Google and Microsoft launch beta versions to accumulate customer feedback to work out bugs before the official launch. Moreover, technology enthusiasts will often pay a premium price to have the latest gadget. The endorsement by technology enthusiasts validates the fact that the new product does in fact work.

A recent example of an innovation that appeals to technology enthusiasts is Google Glass, a mobile computer that is worn like a pair of regular glasses. Instead of a lens,

however, one side displays a small, high-definition computer screen. Google Glass was developed as part of Google's wild-card program. Technology enthusiasts were eager to get ahold of Google Glass when made available in a beta testing program in 2013.

Those interested had to compose a Google+ or Twitter message of 50 words or less explaining why they would be a good choice to test the device and include the hashtag #ifihadglass. Some 150,000 people applied and 8,000 winners were chosen. They were required to attend a Google Glass event and pay \$1,500 for the developer version of Google Glass.

Although many industry leaders, including Apple CEO Tim Cook, agree that wearable computers such as the Apple Watch or the Fitbit (a physical activity tracker that is worn on the wrist; data are integrated into an online community and phone app) are important mobile devices, they suggest that there is a large chasm between the current technology for computerized eyeglasses and a successful product for early adopters let alone the mass market.⁴⁷ They seem to be correct, because Google was until now unable to cross the chasm between technology enthusiasts and early adopters, even after spending \$10 billion on R&D per year.⁴⁸



Google Glass allows the wearer to use the internet and smartphone-like applications via voice commands (e.g., conduct online search, stream video, and so on).

©AP Images/Google/REX

EARLY ADOPTERS. The customers entering the market in the growth stage are *early adopters*. They make up roughly 13.5 percent of the total market potential. Early adopters, as the name suggests, are eager to buy early into a new technology or product concept. Unlike technology enthusiasts, however, their demand is driven by their imagination and creativity rather than by the technology per se. They recognize and appreciate the possibilities the new technology can afford them in their professional and personal lives. Early adopters' demand is fueled more by intuition and vision rather than technology concerns. These are the people that lined up at Apple Stores in the spring of 2015 when it introduced Apple Watch. Since early adopters are not influenced by standard technological performance metrics but by intuition and imagination (What can this new product do for me or my business?), the firm needs to communicate the product's potential applications in a more direct way than when it attracted the initial technology enthusiasts. Attracting the early adopters to the new offering is critical to opening any new high-tech market segment.

EARLY MAJORITY. The customers coming into the market in the shakeout stage are called *early majority*. Their main consideration in deciding whether or not to adopt a new technological innovation is a strong sense of practicality. They are pragmatists and are most concerned with the question of what the new technology can do for them. Before adopting a new product or service, they weigh the benefits and costs carefully. Customers in the early majority are aware that many hyped product introductions will fade away, so they prefer to wait and see how things shake out. They like to observe how early adopters are using the product. Early majority customers rely on endorsements by others. They seek out reputable references such as reviews in prominent trade journals or in magazines such as *Consumer Reports*.

Tesla Motors CEO Elon Musk (left) in front of a Tesla Roadster; Fisker Automotive CEO Henrik Fisker (right) in front of a Fisker Karma.

©Misha Gravenor



Because the early majority makes up roughly one-third of the entire market potential, winning them over is critical to the commercial success of the innovation. They are on the cusp of the mass market. Bringing the early majority on board is the key to catching the growth wave of the industry life cycle. Once they decide to enter the market, a *herding effect* is frequently observed: The early majority enters in large numbers.⁴⁹

The significant differences in the attitudes toward technology of the early majority when compared to the early adopters signify the wide competitive gulf—the *chasm*—between these two consumer segments (see Exhibit 7.8). Without adequate demand from the early majority, most innovative products wither away.

Fisker Automotive, a California-based designer and manufacturer of premium plug-in hybrid vehicles, fell into the chasm because it was unable to transition to early adopters, let alone the mass market. Between its founding in 2007 and 2012, Fisker sold some 1,800 of its Karma model, a \$100,000 sports car, to technology enthusiasts. It was unable, however, to follow up with a lower-cost model to attract the early adopters into the market. In addition, technology and reliability issues for the Karma could not be overcome. By 2013, Fisker had crashed into the first chasm (between technology enthusiasts and early adopters), filing for bankruptcy. The assets of Fisker Automotive were purchased by Wanxiang, a Chinese auto parts maker.⁵⁰

In contrast, Tesla, the maker of all-electric vehicles introduced in ChapterCase 1 and a fierce rival of Fisker at one time, was able to overcome some of the early chasms. The Tesla Roadster was a proof-of-concept car that demonstrated that electric vehicles could achieve an equal or better performance than the very best gasoline-engine sports cars. The 2,400 Roadsters that Tesla built between 2008 and 2012 were purchased by technology enthusiasts. Next, Tesla successfully launched the Model S, a family sedan, sold to early adopters. The Tesla Model S received a strong endorsement as the 2013 *Motor Trend* Car of the Year and the highest test scores ever awarded by *Consumer Reports*. This may help in crossing the chasm to the early majority, because consumers would now feel more comfortable in considering and purchasing a Tesla vehicle. Tesla is hoping to cross the large competitive chasm between early adopters and early majority with its new, lower-priced Model 3.

LATE MAJORITY The next wave of growth comes from buyers in the *late majority* entering the market in the maturity stage. Like the early majority, they are a large customer

segment, making up approximately 34 percent of the total market potential. Combined, the early majority and late majority make up the lion's share of the market potential. Demand coming from just two groups—early and late majority—drives most industry growth and firm profitability.

Members of the early and late majority are also quite similar in their attitudes toward new technology. The late majority shares all the concerns of the early majority. But there are also important differences. Although members of the early majority are confident in their ability to master the new technology, the late majority is not. They prefer to wait until standards have emerged and are firmly entrenched, so that uncertainty is much reduced. The late majority also prefers to buy from well-established firms with a strong brand image rather than from unknown new ventures.

LAGGARDS. Finally, *laggards* are the last consumer segment to come into the market, entering in the declining stage of the industry life cycle. These are customers who adopt a new product only if it is absolutely necessary, such as first-time cell phone adopters in the United States today. These customers generally don't want new technology, either for personal or economic reasons. Given their reluctance to adopt new technology, they are generally not considered worth pursuing. Laggards make up no more than 16 percent of the total market potential. Their demand is far too small to compensate for reduced demand from the early and late majority (jointly almost 70 percent of total market demand), who are moving on to different products and services.

CROSSING THE CHASM: APPLICATION TO THE MOBILE PHONE INDUSTRY. Let's apply the crossing-the-chasm framework to one specific industry. In this model, the transition from stage to stage in the industry life cycle is characterized by different competitive chasms that open up because of important differences between customer groups. Although the large chasm between early adopters and the early majority is the main cause of demise for technological innovations, other smaller mini-chasms open between each stage.

Exhibit 7.9 shows the application of the chasm model to the mobile phone industry. The first victim was Motorola's Iridium, an ill-fated satellite-based telephone system.⁵¹ Development began in 1992 after the spouse of a Motorola engineer complained about being unable to get any data or voice access to check on clients while vacationing

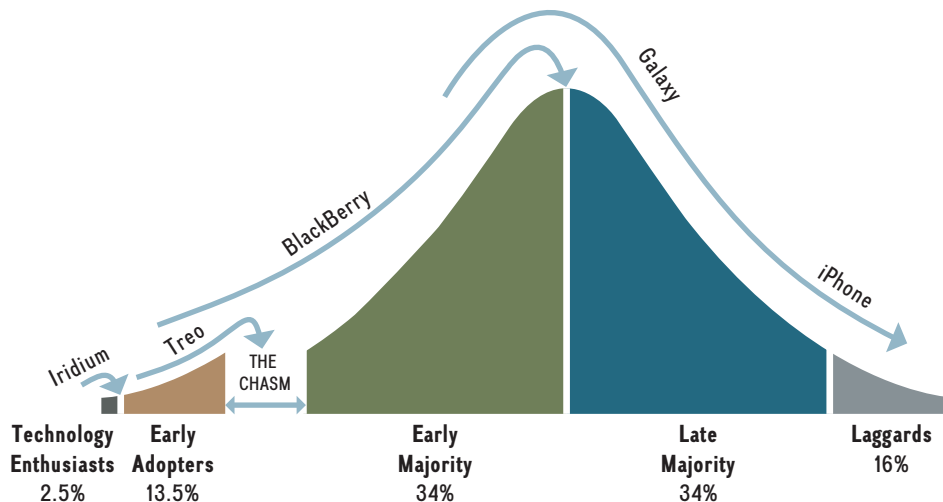


EXHIBIT 7.9 /
Crossing the Chasm: The
Mobile Phone Industry

on a remote island. Motorola's solution was to launch 66 satellites into low orbit to provide global voice and data coverage. In late 1998, Motorola began offering its satellite phone service, charging \$5,000 per handset (which was almost too heavy to carry around) and up to \$14 per minute for calls.⁵² Problems in consumer adoption beyond the few technology enthusiasts became rapidly apparent. The Iridium phone could not be used inside buildings or in cars. Rather, to receive a satellite signal, the phone needed an unobstructed line of sight to a satellite. Iridium crashed into the first chasm, never moving beyond technology enthusiasts (see Exhibit 7.9). For Motorola, it was a billion-dollar blunder. Iridium was soon displaced by cell phones that relied on Earth-based networks of radio towers. The global satellite telephone industry never moved beyond the introductory stage of the industry life cycle.

The first Treo, a fully functioning smartphone combining voice and data capabilities, was released in 2002 by Handspring. The Treo fell into the main chasm that arises between early adopters and the early majority (see Exhibit 7.9). Technical problems, combined with a lack of apps and an overly rigid contract with Sprint as its sole service provider, prevented the Treo from gaining traction in the market beyond early adopters. For these reasons, the Treo was not an attractive product for the early majority, who rejected it. This caused the Treo to plunge into the chasm. Just a year later, Handspring was folded into Palm, which in turn was acquired by HP for \$1 billion in 2010.⁵³ HP shut down Palm in 2011 and wrote off the acquisition.⁵⁴

BlackBerry (formerly known as Research in Motion or RIM)⁵⁵ introduced its first fully functioning smartphone in 2000. It was a huge success—especially with two key consumer segments. First, corporate IT managers were early adopters. They became product champions for the BlackBerry smartphone because of its encrypted security software and its reliability in always staying connected to a company's network. This allowed users to receive e-mail and other data in real time, anywhere in the world where wireless service was provided. Second, corporate executives were the early majority pulling the BlackBerry smartphone over the chasm because it allowed 24/7 access to data and voice. BlackBerry was able to create a beachhead to cross the chasm between the technology enthusiasts and early adopters on one side and the early majority on the other.⁵⁶ BlackBerry's managers identified the needs of not only early adopters (e.g., IT managers) but also the early majority (e.g., executives), who pulled the BlackBerry over the chasm. By 2005, the BlackBerry had become a corporate executive status symbol. As a consequence of capturing the first three stages of the industry life cycle, between 2002 and 2007, BlackBerry enjoyed no less than 30 percent year-over-year revenue growth as well as double-digit growth in other financial performance metrics such as return on equity. BlackBerry enjoyed a temporary competitive advantage.

In 2007, BlackBerry's dominance over the smartphone market began to erode quickly. The main reason was Apple's introduction of the iPhone. Although technology enthusiasts and early adopters argue that the iPhone is an inferior product to the BlackBerry based on technological criteria, the iPhone enticed not only the early majority, but also the late majority to enter the market. For the late majority, encrypted software security was much less important than having fun with a device that allowed users to surf the web, take pictures, play games, and send and receive e-mail. Moreover, the Apple iTunes Store soon provided thousands of apps for basically any kind of service. While the BlackBerry couldn't cross the gulf between the early and the late majority, Apple's iPhone captured the mass market rapidly. Moreover, consumers began to bring their personal iPhone to work, which forced corporate IT departments to expand their services beyond the BlackBerry. Apple rode the wave of this success to capture each market segment. Likewise, Samsung with its Galaxy line of phones, having successfully imitated the look-and-feel of an

iPhone (as discussed in Chapter 4), is enjoying similar success across the different market segments.

This brief application of the chasm framework to the mobile phone industry shows its usefulness. It provides insightful explanations of why some companies failed, while others succeeded—and thus goes at the core of strategy management.

In summary, Exhibit 7.10 details the features and strategic implications of the entire industry life cycle at each stage.

A word of caution is in order, however: Although the industry life cycle is a useful framework to guide strategic choice, industries do not *necessarily evolve* through these stages. Moreover, innovations can emerge at any stage of the industry life cycle, which in turn can initiate a new cycle. Industries can also be rejuvenated, often in the declining stage.

Although the industry life cycle is a useful tool, it does not explain everything about changes in industries. Some industries may never go through the entire life cycle, while others are continually renewed through innovation. Be aware, too, that other external factors that can be captured in the PESTEL framework (introduced in Chapter 3) such as fads

EXHIBIT 7.10 / Features and Strategic Implications of the Industry Life Cycle

Life Cycle Stages					
	Introduction	Growth	Shakeout	Maturity	Decline
Core Competency	R&D, some marketing	R&D, some manufacturing, marketing	Manufacturing, process engineering	Manufacturing, process engineering, marketing	Manufacturing, process engineering, marketing, service
Type and Level of Innovation	Product innovation at a maximum; process innovation at a minimum	Product innovation decreasing; process innovation increasing	After emergence of standard: product innovation decreasing rapidly; process innovation increasing rapidly	Product innovation low; process innovation high	Product innovation at a minimum; process innovation at a maximum
Market Growth	Slow	High	Moderate and slowing down	None to moderate	Negative
Market Size	Small	Moderate	Large	Largest	Small to moderate
Price	High	Falling	Moderate	Low	Low to high
Number of Competitors	Few, if any	Many	Fewer	Moderate, but large	Few, if any
Mode of Competition	Non-price competition	Non-price competition	Shifting from non-price to price competition	Price	Price or non-price competition
Type of Buyers	Technology enthusiasts	Early adopters	Early majority	Late majority	Laggards
Business-Level Strategy	Differentiation	Differentiation	Differentiation, or integration strategy	Cost-leadership or integration strategy	Cost-leadership, differentiation, or integration strategy
Strategic Objective	Achieving market acceptance	Staking out a strong strategic position; generating “deep pockets”	Surviving by drawing on “deep pockets”	Maintaining strong strategic position	Exit, harvest, maintain, or consolidate

in fashion, changes in demographics, or deregulation can affect the dynamics of industry life cycles at any stage.

It is also important to note that innovations that failed initially can sometimes get a second chance in a new industry or for a new application. When introduced in the early 1990s as an early wireless telephone system, Iridium's use never went beyond that by technology enthusiasts. After Motorola's failure, the technology was spun out as a standalone venture called Iridium Communications. As of 2017, it looks like Iridium's satellite-based communications system will get another chance of becoming a true breakthrough innovation.⁵⁷ Rather than in an application in the end-consumer market, this time Iridium is considered for global deployment by airspace authorities to allow real-time tracking of airplanes wherever they may be. The issue of being able to track airplanes around the globe at all times came to the fore in 2014, when Malaysia Airlines Flight 370 with 239 people on board disappeared without a trace, and authorities were unable to locate the airplane.

For the last few decades, air controllers had to rely on ground-based radar to direct planes and to triangulate their positions. A major problem with any ground-based system is that it only works over land or near the shore, but not over oceans, which cover more than 70 percent of the Earth's surface. Moreover, radar does not work in mountain ranges. Oceans and mountain terrain, therefore, are currently dead zones where air traffic controllers are unable to track airplanes.

Iridium's technology is now used as a space-based flight tracking system. In 2017, Elon Musk's SpaceX launched the first set of 10 satellites (out of a total of 66 needed) into space to begin constructing a space-based air traffic control system. Such a system affords air traffic controllers full visibility of and real-time flight information from any airplane over both water and land. It also allows pilots more flexibility in changing routes to avoid bad weather and turbulence, thus increasing passenger convenience, saving fuel, and reducing greenhouse-gas emissions. In addition, the new technology, called Aireon, would allow planes to fly closer together (15 miles apart instead of the now customary 80 miles), allowing for more air traffic on efficient routes. A research study by an independent body predicts that global deployment of Aireon would also lead to a substantial improvement in air safety.

Providing the next-generation air traffic control technology and services is a huge business opportunity for Iridium Communications. National air traffic control agencies will be the main customers to deploy the new Aireon technology. This goes to show that a second chance of success for an innovation may arise, even after the timing and application of an initial technology were off.

LO 7-5

Categorize different types of innovations in the markets-and-technology framework.

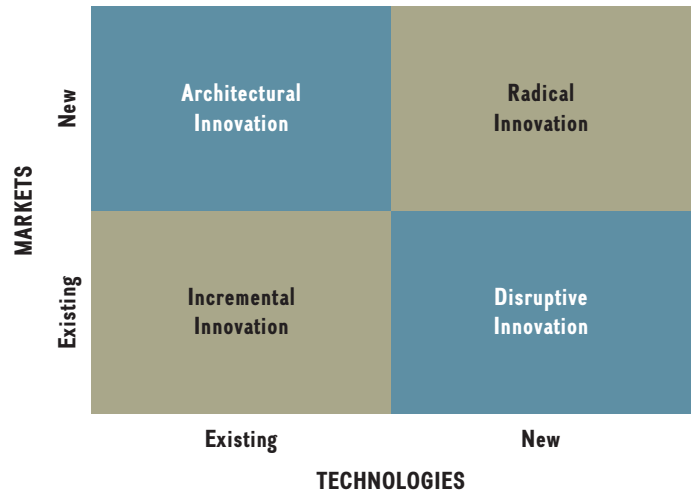
7.4 Types of Innovation

Because of the importance of innovation in shaping competitive dynamics and as a critical component in formulating business strategy, we now turn to a discussion of different types of innovation and the strategic implications of each. We need to know, in particular, along which dimensions we should assess innovations. This will allow us to formulate a business strategy that can leverage innovation for competitive advantage.

One insightful way to categorize innovations is to measure their degree of newness in terms of *technology* and *markets*.⁵⁸ Here, *technology* refers to the methods and materials used to achieve a commercial objective.⁵⁹ For example, Amazon integrates different types of technologies (hardware, software, big data analytics, cloud computing, logistics, and so on) to provide not only the largest selection of retail goods online, but also an array of services and mobile devices (e.g., Alexa, a digital personal assistant;

Kindle tablets; Prime; cloud-computing services; and so on). We also want to understand the *market* for an innovation—e.g., whether an innovation is introduced into a new or an existing market—because an invention turns into an innovation only when it is successfully commercialized.⁶⁰ Measuring an innovation along these dimensions gives us the **markets-and-technology framework** depicted in Exhibit 7.11. Along the horizontal axis, we ask whether the innovation builds on existing technologies or creates a new one. On the vertical axis, we ask whether the innovation is targeted toward existing or new markets. Four types of innovations emerge: incremental, radical, architectural, and disruptive innovations. As indicated by the color coding in Exhibit 7.11, each diagonal forms a pair: incremental versus radical innovation and architectural versus disruptive innovation.

EXHIBIT 7.11 / Types of Innovation: Combining Markets and Technologies



INCREMENTAL VS. RADICAL INNOVATION

Although radical breakthroughs such as smartphones and magnetic resonance imaging (MRI) radiology capture most of our attention, the vast majority of innovations are actually incremental ones. An **incremental innovation** squarely builds on an established knowledge base and steadily improves an existing product or service offering.⁶¹ It targets existing markets using existing technology.

On the other hand, **radical innovation** draws on novel methods or materials, is derived either from an entirely different knowledge base or from a recombination of existing knowledge bases with a new stream of knowledge. It targets new markets by using new technologies.⁶² Well-known examples of radical innovations include the introduction of the mass-produced automobile (the Ford Model T), the X-ray, the airplane, and more recently biotechnology breakthroughs such as genetic engineering and the decoding of the human genome.

Many firms get their start by successfully commercializing radical innovations, some of which, such as the jet-powered airplane, even give birth to new industries. Although the British firm de Havilland first commercialized the jet-powered passenger airplane, Boeing was the company that rode this radical innovation to industry dominance. More recently, Boeing's leadership has been contested by Airbus; each company has approximately half the market. This stalemate is now being challenged by aircraft manufacturers such as Bombardier of Canada and Embraer of Brazil, which are moving up-market by building larger luxury jets that are competing with some of the smaller airplane models offered by Boeing and Airbus.

markets-and-technology framework

A conceptual model to categorize innovations along the market (existing/new) and technology (existing/new) dimensions.

incremental innovation

An innovation that squarely builds on an established knowledge base and steadily improves an existing product or service.

radical innovation

An innovation that draws on novel methods or materials, is derived either from an entirely different knowledge base or from a recombination of the existing knowledge bases with a new stream of knowledge.

A predictable pattern of innovation is that firms (often new ventures) use radical innovation to create a temporary competitive advantage. They then follow up with a string of incremental innovations to sustain that initial lead. Gillette is a prime example for this pattern of strategic innovation. In 1903, entrepreneur King C. Gillette invented and began selling the safety razor with a disposable blade. This *radical innovation* launched the Gillette Co. (now a brand of Procter & Gamble). To sustain its competitive advantage, Gillette not only made sure that its razors were inexpensive and widely available by introducing the “razor and razor blade” business model, but also continually improved its blades. In a classic example of a string of *incremental innovations*, Gillette kept adding an additional blade with each new version of its razor until the number had gone from one to six! Though this innovation strategy seems predictable, it worked. Gillette’s newest razor, the Fusion ProGlide with Flexball technology, a razor handle that features a swiveling ball hinge, costs \$11.49 (and \$12.59 for a battery-operated one) *per razor*! ⁶³ Dollar Shave Club is disrupting Gillette’s business model based on incremental innovation. As a result, Gillette’s market share in the \$15 billion wet shaving industry has declined from some 70 percent (in 2010) to below 60 percent (by 2017). ⁶⁴

The Gillette example, nonetheless, shows how radical innovation created a competitive advantage that the company can sustain through follow-up incremental innovation. Such an outcome is not a foregone conclusion, though. In some instances, the innovator is outcompeted by second movers that quickly introduce a similar incremental innovation to continuously improve their own offering. For example, although CNN was the pioneer in 24-hour cable news, today Fox News is the most watched cable news network in the United States (although the entire industry is in decline as viewers now stream much more content directly via mobile devices, as discussed in ChapterCase 7 about Netflix). Once firms have achieved market acceptance of a breakthrough innovation, they tend to follow up with incremental rather than radical innovations. Over time, these companies morph into industry incumbents. Future radical innovations are generally introduced by new entrepreneurial ventures. Why is this so? The reasons concern *economic incentives*, *organizational inertia*, and the firm’s embeddedness in an *innovation ecosystem*. ⁶⁵

ECONOMIC INCENTIVES. Economists highlight the role of *incentives* in strategic choice. Once an innovator has become an established incumbent firm (such as Google has today), it has strong incentives to defend its strategic position and market power. An emphasis on incremental innovations strengthens the incumbent firm’s position and thus maintains high entry barriers. A focus on incremental innovation is particularly attractive once an industry standard has emerged and technological uncertainty is reduced. Moreover, many markets where network effects are important (such as online search), turn into **winner-take-all markets**, where the market leader captures almost all of the market share. As a near monopolist, the winner in these types of markets is able to extract a significant amount of the value created. In the United States, Google handles some 65 percent of all online queries, while it handles more than 90 percent in Europe. As a result, the incumbent firm uses incremental innovation to extend the time it can extract profits based on a favorable industry structure (see the discussion in Chapter 3). Any potential radical innovation threatens the incumbent firm’s dominant position.

The incentives for entrepreneurial ventures, however, are just the opposite. Successfully commercializing a radical innovation is frequently the only option to enter an industry protected by high entry barriers. One of the first biotech firms, Amgen, used newly discovered drugs based on genetic engineering to overcome entry barriers to the pharmaceutical

winner-take-all markets Markets where the market leader captures almost all of the market share and is able to extract a significant amount of the value created.

industry, in which incumbents had enjoyed notoriously high profits for several decades. Because of differential economic incentives, incumbents often push forward with incremental innovations, while new entrants focus on radical innovations.

ORGANIZATIONAL INERTIA. From an organizational perspective, as firms become established and grow, they rely more heavily on formalized business processes and structures. In some cases, the firm may experience *organizational inertia*—resistance to changes in the status quo. Incumbent firms, therefore, tend to favor incremental innovations that reinforce the existing organizational structure and power distribution while avoiding radical innovation that could disturb the existing power distribution. Take, for instance, power distribution between different functional areas, such as R&D and marketing. New entrants, however, do not have formal organizational structures and processes, giving them more freedom to launch an initial breakthrough. We discuss the link between organizational structure and firm strategy in depth in Chapter 11.

INNOVATION ECOSYSTEM. A final reason incumbent firms tend to be a source of incremental rather than radical innovations is that they become embedded in an **innovation ecosystem**: a network of suppliers, buyers, complementors, and so on.⁶⁶ They no longer make independent decisions but must consider the ramifications on other parties in their innovation ecosystem. Continuous incremental innovations reinforce this network and keep all its members happy, while radical innovations disrupt it. Again, new entrants don't have to worry about preexisting innovation ecosystems, since they will be building theirs around the radical innovation they are bringing to a new market.

innovation ecosystem
A firm's embeddedness in a complex network of suppliers, buyers, and complementors, which requires interdependent strategic decision making.

ARCHITECTURAL VS. DISRUPTIVE INNOVATION

Firms can also innovate by leveraging *existing technologies* into *new markets*. Doing so generally requires them to reconfigure the components of a technology, meaning they alter the overall *architecture* of the product.⁶⁷ An **architectural innovation**, therefore, is a new product in which known components, based on existing technologies, are reconfigured in a novel way to create new markets.

As a radical innovator commercializing the xerography invention, Xerox was long the most dominant copier company worldwide.⁶⁸ It produced high-volume, high-quality, and high-priced copying machines that it leased to its customers through a service agreement. Although these machines were ideal for the high end of the market such as Fortune 100 companies, Xerox ignored small and medium-sized businesses. By applying an architectural innovation, the Japanese entry Canon was able to redesign the copier so that it didn't need professional service—reliability was built directly into the machine, and the user could replace parts such as the cartridge. This allowed Canon to apply the *razor-razor-blade business model* (introduced in Chapter 5), charging relatively low prices for its copiers but adding a steep markup to its cartridges. Xerox had not envisioned the possibility that the components of the copying machine could be put together in an altogether different way that was more user-friendly. More importantly, Canon addressed a need in a specific consumer segment—small and medium-sized businesses and individual departments or offices in large companies—that Xerox neglected.

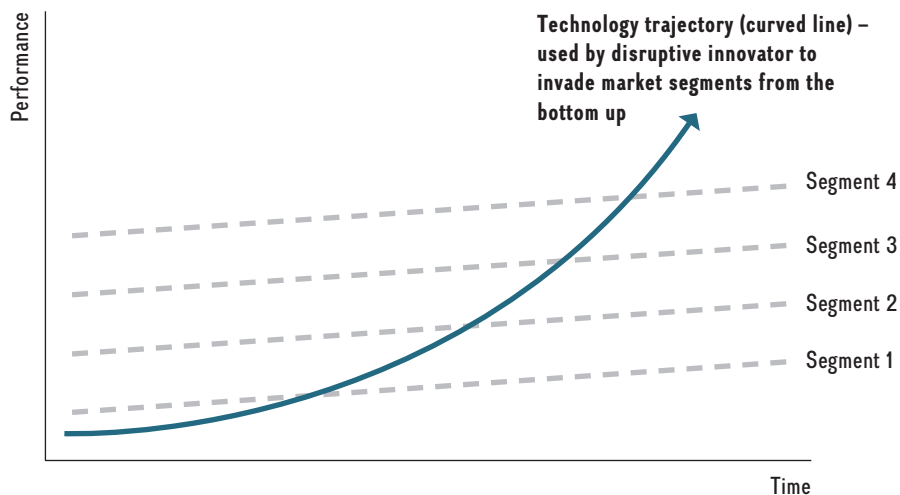
Finally, a **disruptive innovation** leverages *new technologies* to attack *existing markets*. It invades an existing market from the bottom up, as shown in Exhibit 7.12.⁶⁹ The dashed lines represent different market segments, from Segment 1 at the low end to Segment 4 at the high end. Low-end market segments are generally associated with low profit margins,

architectural innovation
A new product in which known components, based on existing technologies, are reconfigured in a novel way to attack new markets.

disruptive innovation
An innovation that leverages new technologies to attack existing markets from the bottom up.

EXHIBIT 7.12

Disruptive Innovation: Riding the Technology Trajectory to Invade Different Market Segments from the Bottom Up



while high-end market segments often have high profit margins. As first demonstrated by Clayton Christensen, the dynamic process of disruptive innovation begins when a firm, frequently a startup, introduces a new product or process based on a new technology to meet existing customer needs. To be a disruptive force, however, this new technology has to have additional characteristics:

1. It begins as a low-cost solution to an existing problem.
2. Initially, its performance is inferior to the existing technology, but its rate of technological improvement over time is faster than the rate of performance increases required by different market segments. In Exhibit 7.12, the solid upward curved line captures the new technology's trajectory, or rate of improvement over time.

The following examples illustrate disruptive innovations:

- Japanese carmakers successfully followed a strategy of disruptive innovation by first introducing small fuel-efficient cars and then leveraging their low-cost and high-quality advantages into high-end luxury segments, captured by brands such as Lexus, Infiniti, and Acura. More recently, the South Korean carmakers Kia and Hyundai have followed a similar strategy.
- Digital photography improved enough over time to provide higher-definition pictures. As a result, it has been able to replace film photography, even in most professional applications.
- Laptop computers disrupted desktop computers; now tablets and larger-screen smartphones are disrupting laptops.
- Educational organizations such as Coursera and Udacity are disrupting traditional universities by offering *massive open online courses* (MOOCs), using the web to provide large-scale, interactive online courses with open access.

One factor favoring the success of disruptive innovation is that it relies on a stealth attack: It invades the market from the bottom up, by first capturing the low end. Many times, incumbent firms fail to defend (and sometimes are even happy to cede) the low end of the market, because it is frequently a low-margin business. Google, for example, is using its mobile operating system, Android, as a beachhead to challenge Microsoft's dominance in the personal computer industry, where 90 percent of machines run Windows.⁷⁰ Google's

Android, in contrast, is optimized to run on mobile devices, the fastest-growing segment in computing. To appeal to users who spend most of their time on the web accessing e-mail and other online applications, for instance, it is designed to start in a few seconds. Moreover, Google provides Android free of charge.⁷¹ In contrast to Microsoft's proprietary Windows operating system, Android is open-source software, accessible to anyone for further development and refinement. Google's Android holds an 85 percent market share in mobile operating systems, while Apple's iOS has 12 percent, and the remaining 3 percent is held by Microsoft's Windows.⁷²

Another factor favoring the success of disruptive innovation is that incumbent firms often are slow to change. Incumbent firms tend to listen closely to their current customers and respond by continuing to invest in the existing technology and in incremental changes to the existing products. When a newer technology matures and proves to be a better solution, those same customers will switch. At that time, however, the incumbent firm does not yet have a competitive product ready that is based on the disruptive technology. Although customer-oriented visions are more likely to guard against firm obsolescence than product-oriented ones (see Chapter 2), they are no guarantee that a firm can hold out in the face of disruptive innovation. One of the counterintuitive findings that Clayton Christensen unearthed in his studies is that it can hurt incumbents to listen too closely to their existing customers. Apple is famous for not soliciting customer feedback because it believes it knows what customers need before they even realize it.

Netflix, featured in the ChapterCase, disrupted the television industry from the bottom up (as shown in Exhibit 7.12) with its online streaming video-on-demand service. Netflix's streaming service differentiated itself from cable television by making strategic trade-offs. By initially focusing on older "rerun TV" (such as *Breaking Bad*) and not including local content or exorbitant expensive live sport events, Netflix was able to price its subscription service considerably lower than cable bundles. Netflix improved the viewing experience by allowing users to watch shows and movies without commercial breaks and on-demand, thus enhancing perceived consumer value. By switching quickly from sending DVDs via postal mail to online streaming, Netflix was able to ride the upward-sloping technology trajectory (shown in Exhibit 7.12) to invade the media industry from the bottom up, all the way to providing premium original content such as *House of Cards*. Netflix's pivot to online streaming was aided by increased technology diffusion (see Exhibit 7.1) as more and more Americans adopted broadband internet connections in the early 2000s.

HOW TO RESPOND TO DISRUPTIVE INNOVATION? Many incumbents tend to dismiss the threat by startups that rely on disruptive innovation because initially their product or service offerings are considered low end and too niche-focused. As late as 2010 (the year Blockbuster filed for bankruptcy), the CEO of Time Warner, one of the incumbent media companies to be disrupted by Netflix, did not take it seriously. When asked about the online streaming service as a potential competitor, he ridiculed the threat as equivalent to the likelihood of the Albanian army taking over the entire world.⁷³ It is critical to have an effective response to disruptive innovation.

Although the examples in the previous section show that disruptive innovations are a serious threat for incumbent firms, some have devised strategic initiatives to counter them:

1. *Continue to innovate in order to stay ahead of the competition.* A moving target is much harder to hit than one that is standing still and resting on existing (innovation) laurels. Amazon is an example of a company that has continuously morphed through innovation,⁷⁴ from a simple online book retailer to the largest ecommerce company, and now to include stores on the ground in the grocery sector. It also offers a personalized digital assistant (Alexa), consumer electronics (Kindle tablets), cloud computing,

and content streaming, among other many other offerings (see ChapterCase 8). Netflix continued to innovate by pivoting to online streaming and away from sending DVDs through the mail.

2. *Guard against disruptive innovation by protecting the low end of the market* (Segment 1 in Exhibit 7.12) by introducing low-cost innovations to preempt stealth competitors. Intel introduced the Celeron chip, a stripped-down, budget version of its Pentium chip, to prevent low-cost entry into its market space. More recently, Intel followed up with the Atom chip, a new processor that is inexpensive and consumes little battery power, to power low-cost mobile devices.⁷⁵ Nonetheless, Intel also listened too closely to its existing personal computer customers such as Dell, HP, Lenovo, and so on, and allowed ARM Holdings, a British semiconductor design company (that supplies its technology to Apple, Samsung, HTC, and others) to take the lead in providing high-performing, low-power-consuming processors for smartphones and other mobile devices.
3. *Disrupt yourself, rather than wait for others to disrupt you.* A firm may develop products specifically for emerging markets such as China and India, and then introduce these innovations into developed markets such as the United States, Japan, or the European Union. This process is called **reverse innovation**,⁷⁶ and allows a firm to disrupt itself. Strategy Highlight 7.2 describes how GE Healthcare invented and commercialized a disruptive innovation in China that is now entering the U.S. market, riding the steep technology trajectory of disruptive innovation shown in Exhibit 7.12.

reverse innovation An innovation that was developed for emerging economies before being introduced in developed economies. Sometimes also called *frugal innovation*.

Strategy Highlight 7.2

GE's Innovation Mantra: Disrupt Yourself!

GE Healthcare is a leader in diagnostic devices. Realizing that the likelihood of disruptive innovation increases over time, GE decided to disrupt itself. A high-end ultrasound machine found in cutting-edge research hospitals in the United States or Europe costs \$250,000. There is not a large market for these high-end, high-price products in developing countries. Given their large populations, however, these countries have a strong medical need for ultrasound devices.

In 2002, a GE team in China, through a bottom-up strategic initiative, developed an inexpensive, portable ultrasound device, combining laptop technology with a probe and sophisticated imaging software. This lightweight device (11 pounds) was first used in rural China. In spring 2009, GE unveiled the new medical device under the name Venue 40 in the United States, at a price of less than \$30,000. There was also high demand from many American general practitioners, who could not otherwise afford the \$250,000 needed to procure a high-end machine (that weighed about 400 pounds). In the fall of 2009, then GE Chairman and CEO Jeff Immelt



GE's Vscan is a wireless ultrasound device priced around \$5,000.
©VCG/Getty Images News/ Getty Images

unveiled the Vscan, an even smaller device that looks like a cross between an early iPod and a flip phone. This wireless ultrasound device is priced around \$5,000. GE views the Vscan as the "stethoscope of the 21st century," which a primary care doctor can hang around her neck when visiting with patients.⁷⁷

7.5 Platform Strategy

Up to this point in our discussion of strategy and competitive advantage, we focused mainly on businesses that operate at one or more stages of the linear value chain (introduced in Chapter 4).

A firm's value chain captures the internal activities a firm engages in, beginning with raw materials and ending with retailing and after-sales service and support. The value chain represents a linear view of a firm's business activities. As such, this traditional system of horizontal business organization has been described as a *pipeline*, because it captures a linear transformation with producers at one end and consumers at the other. Take BlackBerry as an example of a business using a linear pipeline approach based on a step-by-step arrangement for creating and transferring value. This Canadian ex-leader in smartphones conducted internal R&D, designed the phones, then manufactured them (often in company-owned plants), and finally retailed them in partner stores such as AT&T or Verizon, which offered wireless services and after-sales support.

LO 7-6

Explain why and how platform businesses can outperform pipeline businesses.

THE PLATFORM VS. PIPELINE BUSINESS MODELS

Read the examples below, and try to figure out how these businesses' operations differ from the traditional pipeline structure described earlier.⁷⁸

- Valued at \$70 billion in 2017, the ride-hailing service Uber was launched less than 10 years earlier in a single city, San Francisco. Uber is not only disrupting the traditional taxi and limousine business in hundreds of cities around the globe, but also reshaping the transportation and logistics industries, without owning a single car. In the future, Uber might deploy a fleet of driverless cars; it is currently testing autonomous vehicles.
- Reaching close to 2 billion people (out of a total of 7 billion on Earth), Facebook is where people get their news, watch videos, listen to music, and share photos. Garnering some \$30 billion in annual advertising revenues in 2016, Facebook has become one of the largest media companies in the world, without producing a single piece of content.
- China-based ecommerce firm Alibaba is the largest web portal that offers online retailing as well as business-to-business services on a scale that dwarfs Amazon.com and eBay combined. On its Taobao site (similar to eBay), Alibaba offers more than 1 billion products, making it the world's largest retailer without owning a single item of inventory. When going public in 2014 by listing on the New York Stock Exchange (NYSE), Alibaba was the world's largest initial public offering (IPO), valued at \$25 billion. Not even three years later, by early 2017, Alibaba was valued at some \$260 billion, making it one of the most valuable technology companies in the world.

What do Uber, Facebook, and Alibaba have in common? They are *not* organized as traditional linear pipelines, but instead as a **platform businesses**. The five most valuable companies globally (Apple, Alphabet, Microsoft, Amazon, and Facebook) all run platform business models. ExxonMobil, running a traditional linear business model from raw materials (fossil fuels) to distribution (of refined petroleum products) and long the most valuable company in the world, had fallen to number six by 2016.⁷⁹ Based on the 2016 book *Platform Revolution* by Parker, Van Alstyne, and Choudary, platforms can be defined along three dimensions:

1. A platform is a business that enables value-creating interactions between external producers and consumers.

platform business An enterprise that creates value by matching external producers and consumers in a way that creates value for all participants, and that depends on the infrastructure or platform that the enterprise manages.

2. The platform's overarching purpose is to consummate matches among users and facilitate the exchange of goods, services, or social currency, thereby enabling value creation for all participants.
3. The platform provides an infrastructure for these interactions and sets governance conditions for them.

The business phenomenon of platforms, however, is not a new one. *Platforms*, often also called *multi-sided markets*, have been around for millennia. The town squares in ancient cities were marketplaces where sellers and buyers would meet under a set of governing rules determined by the owner or operator (such as what type of wares could be offered, when the marketplace was open for business, which vendor would get what stand on the square, etc.). The credit card, often hailed as the most important innovation in the financial sector over the last few decades,⁸⁰ provides a more recent example of a multi-sided market. Credit cards facilitate more frictionless transactions between vendors and customers because the vendor is guaranteed payment by the bank that issues the credit card, and customers using credit cards can easily transact online without the need to carry cash in the physical world. In addition, credit card users can buy goods or services on credit based on their promise of repaying the bank.

In the digital age, *platforms* are business model innovations that use technology (such as the internet, cloud computing, etc.) to connect organizations, resources, information, and people in an interactive ecosystem where value-generating transactions (such as hailing a ride on Uber, catching up on news on Facebook, or connecting a Chinese supplier to a U.S. retailer via Alibaba) can be created and exchanged. Effective use of technology allows platform firms to drastically reduce the barriers of time and space: Information is available in real time across the globe, and market exchanges can take place effectively across vast distances (i.e., China to the United States) or even in small geographic spaces (such as Tinder, a location-based dating service).

THE PLATFORM ECOSYSTEM

platform ecosystem
The market environment in which all players participate relative to the platform.

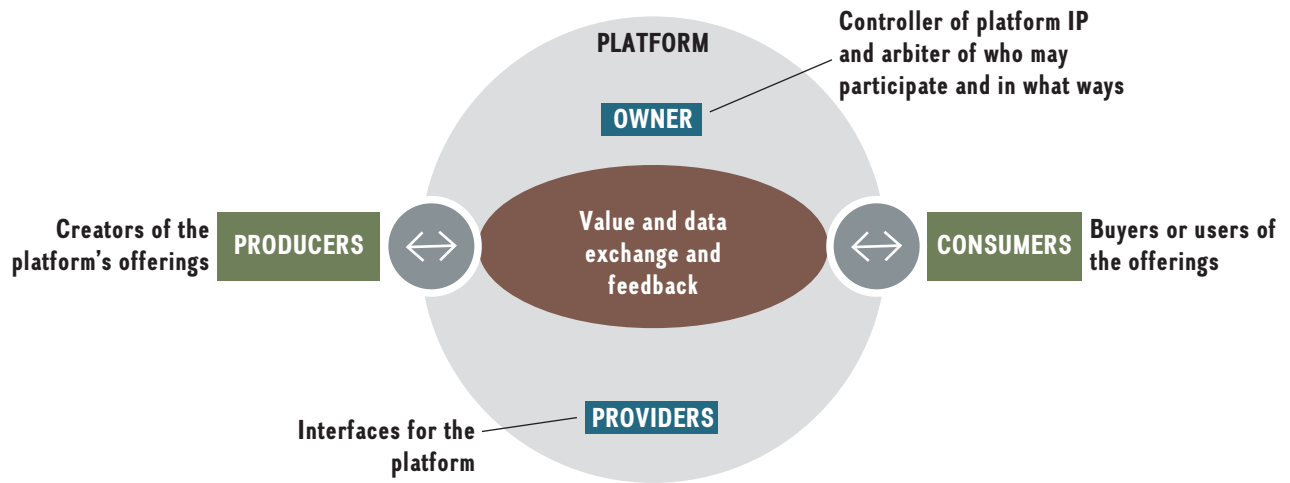
To formulate an effective platform strategy, a first step is to understand the roles of the players within any **platform ecosystem** (see Exhibit 7.13). From a value chain perspective, *producers* create or make available a product or service that *consumers* use. The *owner* of the platform controls the platform IP address and controls who may participate and in what ways. The *providers* offer the interfaces for the platform, enabling its accessibility online.

The players in the ecosystem typically fill one or more of the four roles but may rapidly shift from one role to another. For example, a producer may decide to purchase the platform to become an owner, or an owner may use the platform as a producer. Producer and consumer can also switch, for example, as when a passenger (consumer) who uses Uber for transportation decides to become an Uber driver (producer). This is an example of so-called *side switching*.

ADVANTAGES OF THE PLATFORM BUSINESS MODEL. *Platform businesses* tend to frequently outperform *pipeline businesses*, because of the following advantages:⁸¹

1. *Platforms scale more efficiently than pipelines by eliminating gatekeepers.* Platform businesses leveraging digital technology can also grow much faster—that is, they scale efficiently—because platforms create value by orchestrating resources that reside in the ecosystem. The platform business does not own or control these resources, facilitating rapid and often exponential growth.

In contrast, pipelines tend to be inefficient in managing the flow of information from producer to consumer. When hiring a professional services firm such as consultants or

EXHIBIT 7.13 / The Players in a Platform Ecosystem

SOURCE: Adapted from Van Alstyne, M., Parker, G. G., and Choudary, S. P. (2016, Apr.) "Pipelines, Platforms, and the New Rules of Strategy," *Harvard Business Review*.

lawyers, the buyer has to purchase a bundle of services offered by the firm, for example, retaining a consulting team for a specific engagement. This team of consultants contains both senior and junior consultants, as well as administrative support staff. The client is unable to access the services of only one or two senior partners but not the rest of the team, where inexperienced junior associates are also billed at a high rate to the client. Platforms such as Upwork unbundle professional services by making available precisely defined individual services while eliminating the need to purchase a bundle of services as required by gatekeepers in old-line pipelines.

2. *Platforms unlock new sources of value creation and supply.* Consider how upstart Airbnb (featured in ChapterCase 3) disrupted the hotel industry. To grow, traditional competitors such as Marriott or Hilton would need to add additional rooms to their existing stock. To add new hotel room inventory to their chains, they would need to find suitable real estate, develop and build a new hotel, furnish all the rooms, and hire and train staff to run the new hotel. This often takes years, not to mention the multimillion-dollar upfront investments required and the risks involved.

In contrast, Airbnb faces no such constraints because it does not own any real estate, nor does it manage any hotels. Just like Marriott or Hilton, however, it uses sophisticated pricing and booking systems to allow guests to find a large variety of rooms pretty much anywhere in the world to suit their needs. As a digital platform, Airbnb allows any person to offer rooms directly to pretty much any consumer that is looking for accommodation online. Airbnb makes money by taking a cut on every rental through its platform. Given that Airbnb is a mere digital platform, it can grow much faster than old-line pipeline businesses such as Marriott. Airbnb's inventory is basically unlimited as long as it can sign up new users with spare rooms to rent, combined with very little if any cost to adding inventory to its existing online offerings. Unlike traditional hotel chains, Airbnb's growth is not limited by capital, hotel staff, or ownership of real estate. In 2017, Airbnb offered over 2 million listings worldwide for rent.

3. *Platforms benefit from community feedback.* Feedback loops from consumers back to the producers allow platforms to fine-tune their offerings and to benefit from big data

analytics. TripAdvisor, a travel website, derives significant value from the large amount of quality reviews (including pictures) by its users of hotels, restaurants, and so on. This enables TripAdvisor to consummate more effective matches between hotels and guests via its website, thus creating more value for all participants. It also allows TripAdvisor to capture a percentage of each successful transaction in the process.

Netflix also collects large amounts of data about users' viewing habits and preferences across the world. This allows Netflix to not only make effective recommendations on what to watch next, but also affords a more effective resource allocation process when making content investments. Before even producing a single episode of *House of Cards*, for example, Netflix knew that its audience would watch this series. Netflix has continued following the data, which allows the market to shape new content.

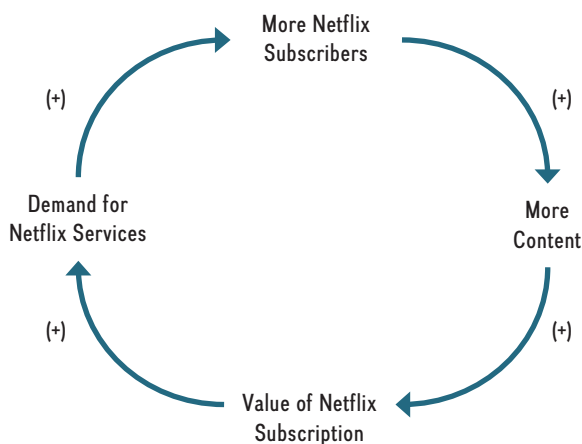
NETWORK EFFECTS For platform businesses to succeed, however, it is critical to benefit from positive *network effects*. We provided a brief introduction of network effects earlier when discussing how to gain a foothold for an innovation in a newly emerging industry during the introduction stage of the industry life cycle. We now take a closer look at the role of network effects in platforms, including feedback loops that can initiate virtuous growth cycles leading to platform leadership.

Netflix. Consider how the video-streaming service Netflix (featured in the ChapterCase) leverages network effects for competitive advantage. Netflix's business model is to grow its global user base as large as possible and then to monetize it via monthly subscription fees. It does not offer any ads. The established customer base in the old-line DVD rental business gave Netflix a head start when entering into the new business of online streaming. Moreover, the cost to Netflix of establishing a large library of streaming content is more or less fixed, but the per unit cost falls drastically as more users join. Moreover, the marginal cost of streaming content to additional users is also extremely low (it is not quite zero because Netflix pays for some delivery of content either by establishing servers hosting content in geographic proximity of users, or paying online service providers for faster content streaming).

As Netflix acquires additional streaming content, it increases the value of its subscription service to customers, resulting in more people signing up. With more customers, Netflix could then afford to provide more and higher-quality content, further increasing the value of the subscription to its users. This created a virtuous cycle that increased the value of a Netflix subscription as more subscribers signed up (see Exhibit 7.14).

Growing its user base is critical for Netflix to sustain its competitive advantage. Netflix has been hugely successful in attracting new users: In 2017 it had some 100 million subscribers worldwide. Yet, while providing a large selection of high-quality streaming content is a necessity of the Netflix business model, this element can and has been easily duplicated by others such as Amazon, Hulu, and premium services on Google's YouTube. To lock in its large installed base of users, however, Netflix has begun producing and distributing original content such as the hugely popular shows *House of Cards* and *Orange Is the New Black*. To sustain its competitive advantage going forward, Netflix needs to rely on its core competencies, including its proprietary recommendation

EXHIBIT 7.14 / Netflix Business Model: Leveraging Network Effects to Drive Demand



engine, data-driven content investments, and network infrastructure management.

Uber. The feedback loop in network effects becomes even more apparent when taking a closer look at Uber's business model. Like many platforms, Uber performs a classic matching service. In this case, it allows riders to find drivers and drivers to find riders. Uber's deep pockets, thanks to successful rounds of fund-raising, allow the startup to lose money on each ride in order to initiate a positive feedback loop. Uber provides incentives for drivers to sign up (such as extending credit so that potential drivers can purchase vehicles) and also charges lower than market rates for its rides. As more and more drivers sign up in each city and thus coverage density rises accordingly, the service becomes more convenient. This drives more demand for its services as more riders choose Uber, which in turn brings in more drivers. This positive feedback loop is shown in Exhibit 7.15.

With more and more drivers on the Uber platform, both wait time for rides as well as driver downtime falls. Less downtime implies that a driver can complete more rides in a given time while making the same amount of money, even if Uber should lower its fares. Lower fares and less wait time, in turn, bring in more riders on the platform, and so on. This additional feedback loop is shown in Exhibit 7.16.

This feedback loop also explains the much hated "surge pricing" that Uber employs. It is based on dynamic pricing for its services depending on demand. For example, during the early hours of each New Year, demand for rides far outstrips supply. To entice more drivers to work during this time, Uber has to pay them more. Higher pay will bring more drivers onto the platform. Some users complain about surge pricing, but it allows Uber to match supply and demand in a dynamic fashion. As surge pricing kicks in, fewer people will demand rides, eventually bringing supply and demand back into an equilibrium (see Exhibit 7.16).

The ability of a platform to evince and manage positive network effects is critical to producing value for each participant, and it allows it to gain and sustain a competitive advantage. In contrast, negative network effects describe the situation where more and more users exit a platform and the value that each remaining user receives from the platform declines. The social network Myspace experienced negative network effects as more and more users abandoned it for Facebook. One reason was that Myspace attempted to maximize ad revenues per user too early in its existence, while Facebook first focused on building a social media platform that allowed for the best possible user experience before starting to monetize its user base through selling ads.

EXHIBIT 7.15 / Uber's Business Model: Leveraging Network Effects to Increase Demand

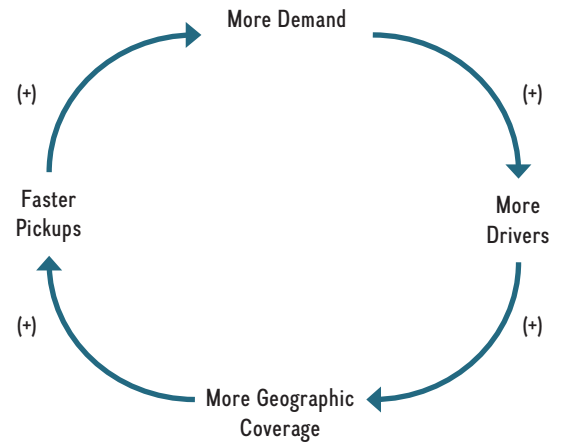
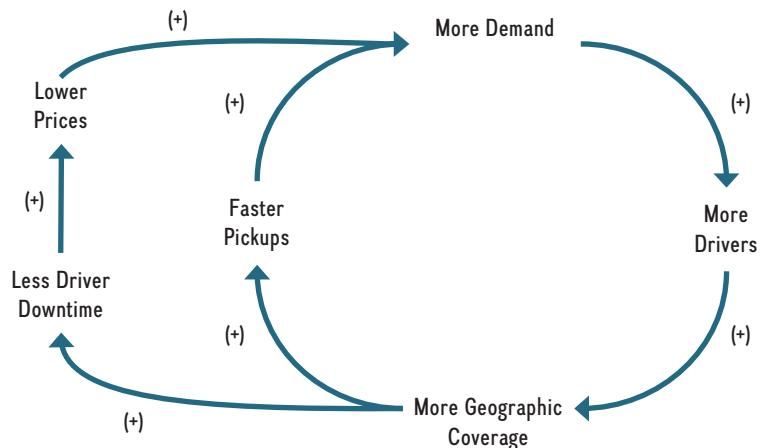


EXHIBIT 7.16 / Uber's Network Effects with Feedback Loop



7.6 Implications for Strategic Leaders

Innovation drives the competitive process. An effective innovation strategy is critical in formulating a business strategy that provides the firm with a competitive advantage. Successful innovation affords firms a temporary monopoly, with corresponding monopoly pricing power. *Fast Company* named Amazon, Google, Uber, Apple, and Snap as the top five of its 2017 Most Innovative Companies.⁸² Continuous innovation fuels the success of these companies.

Entrepreneurs are the agents that introduce change into the competitive system. They do this not only by figuring out how to use inventions, but also by introducing new products or services, new production processes, and new forms of organization. Entrepreneurs frequently start new ventures, but they may also be found in existing firms.

The industry life cycle model and the crossing-the-chasm framework have critical implications for how you manage innovation. To overcome the chasm, you need to formulate a business strategy guided by the who, what, why, and how questions of competition (Chapter 6) to ensure you meet the distinctly different customer needs inherent along the industry life cycle. You also must be mindful that to do so, you need to bring different competencies and capabilities to bear at different stages of the industry life cycle.

It is also useful to categorize innovations along their degree of newness in terms of *technology* and *markets*. Each diagonal pair—incremental versus radical innovation and architectural versus disruptive innovation—has different strategic implications.

Moving from the traditional pipeline business to a platform business model implies three important shifts in strategy focus:⁸³

1. From resource control to resource orchestration.
2. From internal optimization to external interactions.
3. From customer value to ecosystem value.

The focus in platform strategy, therefore, shifts from traditional concepts of resource control, industry structure, and firm strategic position to creating and facilitating more or less frictionless market exchanges.

In conclusion, in this and the previous chapter, we discussed how firms can use *business-level strategy*—differentiation, cost leadership, blue ocean, and innovation—to gain and sustain competitive advantage. We now turn our attention to *corporate-level strategy* to help us understand how executives make decisions about *where to compete* (in terms of products and services offered, integration along the value chain, and geography) and how to execute it through strategic alliances as well as mergers and acquisitions. A thorough understanding of business and corporate strategy is necessary to formulate and sustain a winning strategy.

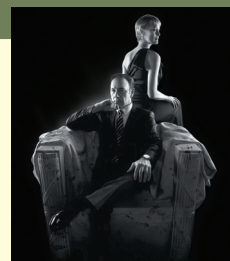
CHAPTERCASE 7 / Consider This. . .

THE IMPACT OF NETFLIX'S mega-success *House of Cards* in reshaping the TV industry cannot be underestimated. The American political TV drama starring Kevin Spacey and Robin Wright was an innovation that fundamentally changed the existing business model of TV viewing on three fronts.

1. **Delivery.** *House of Cards* was the first time that a major original TV drama was streamed online and thus

bypassed the established ecosystem of networks and cable operators.

2. **Access.** *House of Cards* created the phenomenon of binge watching because it allowed Netflix subscribers



©A-Pix Entertainment/
Photofest

to view many or all episodes in one sitting, without any advertising interruptions. As of 2017, spending an estimated \$200 million, Netflix produced five seasons for a total of 65 episodes each roughly 45 to 60 minutes long.

3. Management. *House of Cards* was the first time original programming had been developed based on Netflix's proprietary data algorithms and not by more traditional methods. When executive producer David Fincher and actor Kevin Spacey brought the proposed show to Netflix, the company approved the project without a pilot or any test-marketing. "Netflix was the only network that said, 'We believe in you,'" recalls Spacey. "'We've run our data and it tells us that our audience would watch this series. We don't need you to do a pilot. How many [episodes] do you wanna do?'"⁸⁴

The success of *House of Cards* created a huge buzz, attracted millions of new subscribers to Netflix, and helped its stock climb to new highs.

Despite riding high, there are some serious challenges for CEO Reed Hastings and Netflix on the horizon. First is the issue of how to ensure that Netflix users have a seamless, uninterrupted viewing experience, without buffering (and seeing the "spinning wheels"). Recall that Netflix is responsible for more than one-third of all downstream internet traffic in the United States during peak hours. For a long time, Netflix has been a strong supporter of *net neutrality*, with the goal of preventing internet service providers (ISPs) such as Comcast from slowing content or blocking access to certain websites. Conceivably, Comcast may have an incentive to slow Netflix's content and favor its own NBC content.

To work around the net neutrality rules, ISPs have begun imposing "data caps" on their customers. Once users exceed their data cap, additional data usage incurs added fees. Another ISP practice that concerns Hastings is "zero-rating," an arrangement where the ISP does not count traffic from preferred data providers such as their own content toward customers' data caps. These are the reasons Netflix—after refusing to do so for a long time—has begun to pay ISPs directly to ensure a smoother streaming experience for its users. Rather than going through the public internet, in exchange for payment, Netflix is able to hook its servers directly to Comcast's broadband network. Given its precedent, Netflix is likely to strike similar deals with other ISPs, such as AT&T and Verizon, that control access to Netflix customers.

The second issue for Hastings is how to create sustained future growth. The domestic market seems to be maturing, so growth has to come from international expansion. Some

49 million (or about half of) Netflix subscribers reside outside the United States. To drive future growth, Netflix is rapidly expanding its services internationally from 60 countries in 2016 to 190 countries. Netflix is still noticeably absent from China, a market where Hastings commented that Netflix is still, "in the relationship building phase."⁸⁵ One of the issues Netflix will face is potential censoring of its content; *House of Cards* has not only explicit content in terms of nudity and violence, but also features a corrupt Chinese businessman meddling in U.S. politics. Moreover, problems with a lack of available titles and few places with broadband internet connections hamper Netflix's international growth.

Questions

1. Netflix started to pay ISPs to ensure fast and seamless access to its end users.
 - a. Does this violate *net neutrality* (the rule that internet service providers should treat all data equally, and not charge differentially by user, content, site, etc.)? Why or why not?
 - b. Do you favor net neutrality? Explain why or why not?
 - c. How do ISPs use "zero-rating" of data to circumvent net neutrality rules? Is this legal? Is this ethical? Explain.
 - d. As ISPs will extract more fees from Netflix, the company continues to invest heavily in its proprietary "Open Connect" network, which allows Netflix to connect its servers directly to those of ISPs (via *peering*). Since most users upgrade their internet connections to faster broadband in order to watch video, are the incentives of broadband providers aligned with Netflix, or will the broadband providers continue to extract significant value from this industry? Apply a five forces analysis.
2. Netflix growth in the United States seems to be maturing. What other services can Netflix offer that might increase demand in the United States?
3. International expansion appears to be a major growth opportunity for Netflix. Elaborate on the challenges Netflix faces going beyond the U.S. market.
 - a. Do you think it is a good idea to rapidly expand to 190 countries in one fell swoop, or should Netflix follow a more gradual international expansion?
 - b. What are some of the challenges Netflix is likely to encounter internationally? What can Netflix do to address these? Explain.

TAKE-AWAY CONCEPTS

This chapter discussed various aspects of innovation and entrepreneurship as a business-level strategy, as summarized by the following learning objectives and related take-away concepts.

LO 7-1 / Outline the four-step innovation process from idea to imitation.

- Innovation describes the discovery and development of new knowledge in a four-step process captured in the four I's: *idea*, *invention*, *innovation*, and *imitation*.
- The innovation process begins with an idea.
- An invention describes the transformation of an idea into a new product or process, or the modification and recombination of existing ones.
- Innovation concerns the commercialization of an invention by entrepreneurs (within existing companies or new ventures).
- If an innovation is successful in the marketplace, competitors will attempt to imitate it.

LO 7-2 / Apply strategic management concepts to entrepreneurship and innovation.

- Entrepreneurship describes the process by which change agents undertake economic risk to innovate—to create new products, processes, and sometimes new organizations.
- Strategic entrepreneurship describes the pursuit of innovation using tools and concepts from strategic management.
- Social entrepreneurship describes the pursuit of social goals by using entrepreneurship. Social entrepreneurs use a triple-bottom-line approach to assess performance.

LO 7-3 / Describe the competitive implications of different stages in the industry life cycle.

- Innovations frequently lead to the birth of new industries.
- Industries generally follow a predictable industry life cycle, with five distinct stages: introduction, growth, shakeout, maturity, and decline.
- Exhibit 7.10 details features and strategic implications of the industry life cycle

LO 7-4 / Derive strategic implications of the crossing-the-chasm framework.

- The core argument of the crossing-the-chasm framework is that each stage of the industry life cycle is dominated by a different customer group, which responds differently to a new technological innovation.
- There exists a significant difference between the customer groups that enter early during the introductory stage of the industry life cycle and customers that enter later during the growth stage.
- This distinct difference between customer groups leads to a big gulf or chasm, which companies and their innovations frequently fall into.
- To overcome the chasm, managers need to formulate a business strategy guided by the who, what, why, and how questions of competition.

LO 7-5 / Categorize different types of innovations in the markets-and-technology framework.

- Four types of innovation emerge when applying the existing versus new dimensions of technology and markets: incremental, radical, architectural, and disruptive innovations (see Exhibit 7.11).
- An incremental innovation squarely builds on an established knowledge base and steadily improves an existing product or service offering (existing market/existing technology).
- A radical innovation draws on novel methods or materials and is derived either from an entirely different knowledge base or from the recombination of the existing knowledge base with a new stream of knowledge (new market/new technology).
- An architectural innovation is an embodied new product in which known components, based on existing technologies, are reconfigured in a novel way to attack new markets (new market/existing technology).
- A disruptive innovation is an innovation that leverages new technologies to attack existing markets from the bottom up (existing market/new technology).

LO 7-6 / Explain why and how platform businesses can outperform pipeline businesses.

- Platform businesses scale more efficiently than pipeline businesses by eliminating gatekeepers and leveraging digital technology. Pipeline businesses rely on gatekeepers to manage the flow of value from end to end of the pipeline. Platform businesses leverage technology to provide real-time feedback.
- Platforms unlock new sources of value creation and supply. Thus they escape the limits faced by a pipeline company working within an existing industry based on physical assets.
- Platforms benefit from community feedback. Feedback loops from consumers back to the producers allow platforms to fine-tune their offerings and to benefit from big data analytics.

KEY TERMS

Architectural innovation (p. 245)	Innovation (p. 223)	Process innovation (p. 231)
Crossing-the-chasm framework (p. 235)	Innovation ecosystem (p. 245)	Product innovation (p. 231)
Disruptive innovation (p. 245)	Invention (p. 222)	Radical innovation (p. 243)
Entrepreneurs (p. 226)	Markets-and-technology framework (p. 243)	Reverse innovation (p. 248)
Entrepreneurship (p. 225)	Network effects (p. 229)	Social entrepreneurship (p. 226)
First-mover advantages (p. 224)	Patent (p. 223)	Standard (p. 230)
Incremental innovation (p. 243)	Platform business (p. 249)	Strategic entrepreneurship (p. 226)
Industry life cycle (p. 227)	Platform ecosystem (p. 250)	Trade secret (p. 223)
		Winner-take-all markets (p. 244)

DISCUSSION QUESTIONS

1. Patents are discussed as part of the invention phase of the innovation process in Exhibit 7.2. Describe the trade-offs that are made when a firm decides to patent its business processes or software. Is this same trade-off applicable to tangible hardware products made by a firm?
2. Select an industry and consider how the industry life cycle has affected business strategy for the firms in that industry over time. Detail your answer based on each stage: introduction, growth, shakeout, maturity, and decline.
3. Describe a firm you think has been highly innovative. Which of the four types of innovation—radical, incremental, disruptive, or architectural—did it use? Did the firm use different types over time?
4. The chapter discussed the internet as a disruptive innovation that has facilitated online retailing. It also has presented challenges to brick-and-mortar retailers. How might retailers such as Nordstrom, Neiman Marcus, or Macy's need to change their in-store experience to continue to attract a flow of customers into their stores to expand sales using direct selling and store displays of the actual merchandise? If the internet continues to grow and sales of brick-and-mortar retailers decline, how might the retailers attract, train, and retain high-quality employees if the industry is perceived as in decline?

ETHICAL/SOCIAL ISSUES

1. You are a co-founder of a start-up firm making electronic sensors. After a year of sales, your business is not growing rapidly, but you have some steady customers keeping the business afloat. A major supplier has informed you it can no longer supply your firm because it is moving to serve large customers only, and your volume does not qualify. Though you have no current orders to support an increased commitment to this supplier, you do have a new version of your sensor coming out that you hope will increase the purchase volume by over 75 percent and qualify you for continued supply. This supplier is important to your plans. What do you do?
2. GE's development of the Vscan provides many benefits as a lower-cost and portable ultrasound device (see Strategy Highlight 7.2). Cardiologists, obstetricians, and veterinarians will be able to use the device in rural areas and developing countries. One of the criticisms of the device, however, is that it also facilitates the use of the technology for

gender-selective abortion. In India, for example, there is a cultural preference for males, and the Vscan has been used to identify gender in order to abort an unwanted female fetus. Some argue that gender selection is also used for economic reasons—specifically, to alleviate the financial strain of the common dowry practice. A daughter would require the family to pay a dowry of cash and gifts to the bridegroom's family in order to arrange a suitable marriage, while a son would bring in a dowry of cash, jewelry, gifts, and household items to help the couple start their home.⁸⁶

To what extent is GE ethically responsible for how—and why—the Vscan is used? (To what extent is any company ethically responsible for how—and why—its product is used?) Note that GE's website states that it is an "Agent of Good." Consider ways that GE might become involved in communities in India to show the company's concern for the underlying problems by improving conditions for women. What other ways might GE influence how its equipment is used?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Your group works for Warner Music Group (www.wmg.com), a large music record label whose sales are declining largely due to digital piracy and online sales overall. Your supervisor assigns you the task of developing a strategy for improving this situation.

1. What are the key issues you must grapple with to improve the position of Warner Music Group (WMG)?
2. In what phase of the life cycle is the record-label industry?
3. How does this life cycle phase affect the types of innovation that should be considered to help WMG be successful?

//// Small Group Exercise 2

The text discusses the pros and cons of pipeline businesses and platform businesses. Several examples

of new platform businesses are mentioned (Uber, Airbnb, Facebook, and Alibaba, for example). Yet it is noted that these multi-sided markets have actually been around much longer.

1. What are some of the biggest differences in the historical way to view platform markets and the more modern business incarnation?
2. In your group, discuss a company that could be moving toward a platform business or a new firm that is developing as a platform. Sketch out a business model for this firm and the network loop it could be utilizing to drive demand.
3. Can you identify a pipeline business that is likely to be disrupted by the firm you discussed in question 2 above? What could this pipeline business do to improve its long-term viability?

mySTRATEGY

Do You Want to Be an Entrepreneur?

Recent years have seen a sometimes public debate around the question of whether entrepreneurs are better off skipping college. For reasons noted below, we think this is a false debate, and we'll explain why. But before we're done, we will identify an unexpected way in which a higher education can legitimately be seen as limiting one's ability to innovate and start a new business.⁸⁷

Let's start by acknowledging there are complex links between education and entrepreneurship and by explicitly stating our point of view: The right person can become an entrepreneur without the benefit of a college degree. But having a college degree is no impediment to becoming an entrepreneur and can further provide the benefit of formally studying the dynamics of business—just as we are doing in this class.

One volley in the debate was a provocative article in *Forbes*, titled “The Secret to Entrepreneurial Success: Forget College.” Another article listed 100 impressive entrepreneurs, none with a college degree and some with only an elementary school education. And while some famous entrepreneurs neglected higher education (Mark Zuckerberg dropped out of Harvard; Steve Jobs dropped out of Reed College), entrepreneurs are more likely to be better educated than most business owners. Just over half of business owners have a college degree.

And while the very different entrepreneurs in this chapter were chosen for their business success and innovations, and not their education, they—Jeff Bezos, Sara Blakely, Reed Hastings, Elon Musk, and Jimmy Wales—all have college degrees.

On the student side, business majors are drawn to the entrepreneurial role. Over the past 20 years, there has been an explosion of entrepreneurial programs at business schools, all in response to demand. Some 50 to 75 percent of MBA students from the leading programs are becoming entrepreneurs within 15 years of graduation.

But there is a more likely way in which higher education could be the enemy of entrepreneurship: the impact of large student loans. According to a new report, the higher the student loan debt in an area, the lower the net creation of very small businesses. The correlation of those two factors comes with some caveats:

- These effects tend to affect only the smallest businesses, which are more likely to take on debt that's secured by the founder's own personal credit.
 - The authors of the report stop short of claiming that heavy debt burdens hamper an individual's attempt.
 - An alternate view of the data would be that students with high debt load go directly to higher paying corporate jobs.
1. Thinking about today's business climate, would you say that now is a good time to start a business? Why or why not?
 2. Do you see higher education as a benefit or detriment to becoming a successful entrepreneur? Why or why not?
 3. Identify both the up and down sides of taking on personal debt to finance a higher education.
 4. Explain how you would apply the strategic management framework to enhance your startup's chances to gain and sustain a competitive advantage.

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CHAPTER

8

Corporate Strategy: Vertical Integration and Diversification

Chapter Outline

- 8.1 What Is Corporate Strategy?**
Why Firms Need to Grow
Three Dimensions of Corporate Strategy
- 8.2 The Boundaries of the Firm**
Firms vs. Markets: Make or Buy?
Alternatives on the Make-or-Buy Continuum
- 8.3 Vertical Integration along the Industry Value Chain**
Types of Vertical Integration
Benefits and Risks of Vertical Integration
When Does Vertical Integration Make Sense?
Alternatives to Vertical Integration
- 8.4 Corporate Diversification: Expanding Beyond a Single Market**
Types of Corporate Diversification
Leveraging Core Competencies for Corporate Diversification
Corporate Diversification and Firm Performance
- 8.5 Implications for Strategic Leaders**

Learning Objectives

- LO 8-1** Define corporate strategy and describe the three dimensions along which it is assessed.
- LO 8-2** Explain why firms need to grow, and evaluate different growth motives.
- LO 8-3** Describe and evaluate different options firms have to organize economic activity.
- LO 8-4** Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.
- LO 8-5** Identify and evaluate benefits and risks of vertical integration.
- LO 8-6** Describe and examine alternatives to vertical integration.
- LO 8-7** Describe and evaluate different types of corporate diversification.
- LO 8-8** Apply the core competence–market matrix to derive different diversification strategies.
- LO 8-9** Explain when a diversification strategy does create a competitive advantage and when it does not.

Amazon.com: To Infinity and Beyond

WHEN JEFF BEZOS started Amazon.com out of a garage in a Seattle suburb to sell books online, he furnished his makeshift office with discarded wood doors for desks. In less than 25 years, Amazon morphed from a fledgling startup into one of the world's most valuable companies, active in far-flung businesses from ecommerce and cloud computing to media entertainment and groceries. Yet, wood doors turning into desks remain a staple at Amazon, where strict cost control is paramount to this day. At the same time, in pursuing its mission of being the "earth's most customer-centric company," Amazon excels at customer service. Indeed, a recent survey ranked Amazon as the most well-regarded company in the United States.

Amazon.com's website went live in 1995 and was an instant success with booklovers everywhere. The online startup set itself apart from other internet merchants by pioneering one-click shopping, customer reviews, and order verification via e-mail. Next, Amazon executed a series of strategic alliances and acquisitions to rapidly expand its product and service offerings. In 2000, Amazon started to offer Marketplace, which is a platform on which independent third-party sellers can access Amazon customers globally. In 2005, Amazon launched its Prime membership service. Subscribers pay \$99 a year and receive free two-day shipping, as well as access to Amazon's video and music streaming services. Besides offering every imaginable product online, it sells its own line of consumer electronics such as tablets, e-readers, and voice-enabled wireless devices such as Echo. Among them, the Kindle e-reader (launched in 2007) has transformed the publishing industry. Amazon holds two-thirds market share in e-books and now sells more e-books

than print books. Launched in 2014, Echo is powered by Amazon's Alexa, an intelligent digital assistant that marks Amazon's foray into augmented reality. It plays any song you request, reads aloud your audiobooks, shares the latest news and weather forecast, controls your home's thermostat and lights, and even turns on the home alarm or the yard's sprinkler system. Exhibit 8.1 depicts Amazon's key strategic initiatives and stock market valuation over the years.

Carrying the moniker "the everything store," Amazon has become the largest online retailer in the United States, with an estimated 400 million items available, some 50 times the

number sold by Walmart, the world's largest traditional retailer. Globally, only Alibaba, China's leading ecommerce conglomerate, is larger than Amazon. Besides offering a wide variety of products and services, Amazon also diversified geographically pretty much from the outset. In 1998, it added country-specific sites in the United Kingdom (amazon.co.uk) and Germany (amazon.de) to accommodate its growing



Jeff Bezos is founder and CEO of Amazon.com, one of the world's most valuable companies.

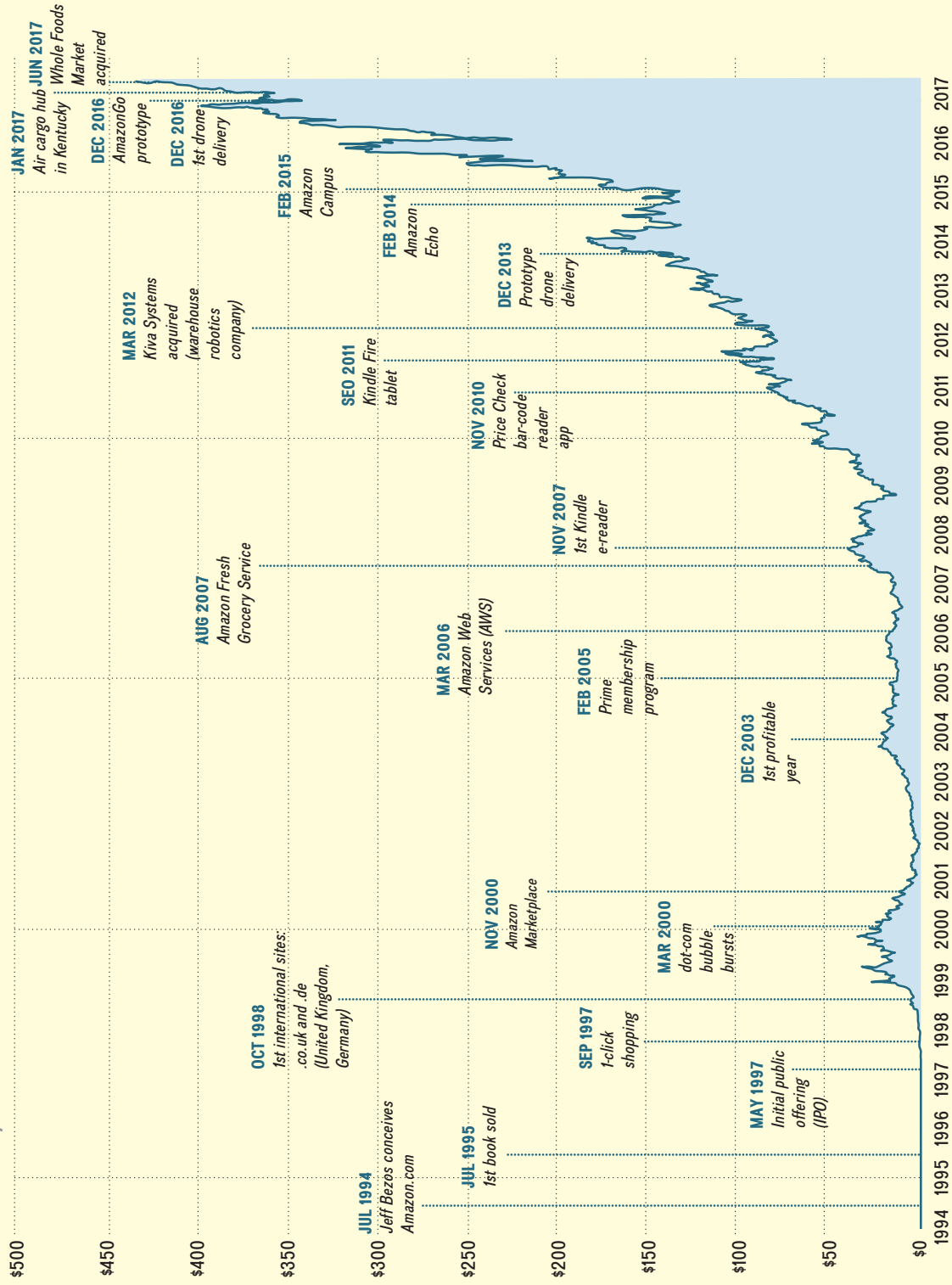
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popularity in Europe. French (amazon.fr) and Japanese (amazon.co.jp) Amazon sites debuted in 2000. Today, Amazon operates country-specific sites in more than a dozen countries, including in China (amazon.cn), and is making a major push into India (amazon.in), where the domestic Flipkart—started by former Amazon employees—took an early lead.

In addition to diversification in products and services as well as geography, Amazon also integrated vertically. Created in 2006, Amazon Web Services (AWS) is a cloud-based computing service, including software applications, data storage, content delivery, payment and billing systems, and other business applications. Today, AWS is the world's largest cloud-computing provider. It is also Amazon's most profitable business endeavor. In 2016, AWS gross revenues were \$12 billion, with \$1 billion in profits. That is, AWS' contribution to Amazon's total revenues of

EXHIBIT 8.1

Amazon's Strategic Initiatives and Stock Market Valuation (in \$ billion), 1994–2017



SOURCE: Depiction of publicly available data.

\$136 billion was 9 percent, while its profit contribution was 74 percent. By developing its own streaming video content (such as *The Man in the High Castle*, an alternative history about the Axis winning World War II), Amazon integrated into media production.

Amazon continues to innovate. Besides offering same-day delivery of groceries in some metropolitan areas and testing drones for even faster distribution, Amazon has introduced checkout free shopping in physical retail outlets (AmazonGo). In 2017 it became apparent these actions were a prelude to its acquisition of Whole Foods Market. Amazon will use AmazonGo at Whole Foods, reduce its labor force, and cut prices by a large margin to further grow its business.

Another recent innovation was AmazonCampus, a student-centered program. Amazon runs co-branded university-specific websites (such as purdue.amazon.com) that offer textbooks, paraphernalia such as the ubiquitous logo sweat-shirts and baseball hats, and even ramen noodles! As part of this new campus initiative, Amazon offers its Prime membership to students at a 50 percent discount (\$49 a year) and guarantees unlimited next-day delivery of any goods

ordered online, besides all the other Prime membership benefits (free streaming of media content, lending one e-book a month for free, discounts on hardware, etc.). To accomplish next-day delivery, Amazon is building fashionable delivery centers on campus, co-branded with the local university such as “amazon@purdue.” Once a package arrives, students receive a text message and can then retrieve it via code-activated lockers or from Amazon employees directly. The on-campus delivery facilities also serve as convenient return centers.

With a market capitalization of some \$500 billion, Amazon is one of the top five most valuable technology companies in the world, besides Apple, Alphabet (Google’s parent company), Microsoft, and Facebook. Over the past decade, Amazon’s stock appreciated by 2,000 percentage points, while the stock market overall (as proxied by the Dow Jones Industrial Average) grew by 62 percentage points over the same time period.¹

You will learn more about Amazon.com by reading this chapter; related questions appear in “ChapterCase 8 / Consider This . . .”



OVER TIME, AMAZON.COM has morphed from a mere online book retailer into the “everything store.”² In the process, it transformed into one of the world’s largest retailers (larger than both brick-and-mortar retailers such as Walmart and most other online retailers). From books, Amazon diversified into consumer electronics, media content, cloud-computing services, and other business endeavors. Jeff Bezos decided to compete in a number of different industries, some related to Amazon’s core business of online retailing, some unrelated.

How does an online bookseller turn into one of the most valuable tech companies on the planet? The short answer: Vertical integration and diversification! Amazon is now a widely diversified as well as integrated technology company. *Vertical integration* refers to the firm’s ownership of its production of needed inputs or of the channels by which it distributes its outputs. Amazon, for example, now creates its own video content, which it distributes through its streaming services. *Diversification* encompasses the variety of products and services a firm offers or markets and the geographic locations in which it competes. Amazon offers a wide range of products and services. By virtue of being an online business, Amazon has a global presence, reinforced by country-specific investments in specialized sites (such as amazon.de in Germany).

But how does a business such as Amazon.com decide exactly *where to compete*? Answers to this important question—in terms of products and services offered, value chain activities, or geographic markets—are captured in a firm’s *corporate strategy*, which we cover in the next three chapters. In this chapter, we define corporate strategy and then look at two fundamental corporate strategy topics: vertical integration and diversification. We conclude the chapter with *Implications for Strategic Leaders*, providing a practical application of dynamic corporate strategy at Nike and Adidas.

LO 8-1

Define corporate strategy and describe the three dimensions along which it is assessed.

corporate strategy The decisions that senior management makes and the goal-directed actions it takes to gain and sustain competitive advantage in several industries and markets simultaneously.

8.1 What Is Corporate Strategy?

Strategy formulation centers around the key questions of *where and how* to compete. *Business strategy* concerns the question of *how to compete* in a *single product market*. As discussed in Chapter 6, the two generic business strategies that firms can follow to pursue their quest for competitive advantage are to increase differentiation (while containing cost) or lower costs (while maintaining differentiation). If trade-offs can be reconciled, some firms might be able to pursue a blue ocean strategy by increasing differentiation and lowering costs. As firms grow, they are frequently expanding their business activities through seeking new markets both by offering new products and services and by competing in different geographies. Strategic leaders must formulate a corporate strategy to guide continued growth. To gain and sustain competitive advantage, therefore, any corporate strategy must align with and strengthen a firm's business strategy, whether it is a differentiation, cost-leadership, or blue ocean strategy.

Corporate strategy comprises the decisions that leaders make and the goal-directed actions they take in the quest for competitive advantage in several industries and markets simultaneously.³ It provides answers to the key question of *where to compete*. Corporate strategy determines the boundaries of the firm along three dimensions: *vertical integration* along the industry value chain, *diversification* of products and services, and *geographic scope* (regional, national, or global markets). Strategic leaders must determine corporate strategy along the three dimensions:

1. *Vertical integration*: In what stages of the industry value chain should the company participate? The industry value chain describes the transformation of raw materials into finished goods and services along distinct vertical stages.
2. *Diversification*: What range of products and services should the company offer?
3. *Geographic scope*: Where should the company compete geographically in terms of regional, national, or international markets?

In most cases, underlying these three questions is an implicit desire for growth. The need for growth is sometimes taken so much for granted that not every manager understands all the reasons behind it. A clear understanding will help strategic leaders to pursue growth for the right reasons and make better decisions for the firm and its stakeholders.

LO 8-2

Explain why firms need to grow, and evaluate different growth motives.

WHY FIRMS NEED TO GROW

Several reasons explain *why firms need to grow*. These can be summarized as follows:

1. Increase profits.
2. Lower costs.
3. Increase market power.
4. Reduce risk.
5. Motivate management.

Let's look at each reason in turn.

INCREASE PROFITS. Profitable growth allows businesses to provide a higher return for their shareholders, or owners, if privately held. For publicly traded companies, the stock market valuation of a firm is determined to some extent by expected future revenue and profit streams. As featured in the ChapterCase, Amazon's high stock market valuation is based to a large extent on expectations of future profitability, because the company invests for the long term and as such has yet to show consistent profitability.

If firms fail to achieve their growth target, their stock price often falls. With a decline in a firm's stock price comes a lower overall market capitalization, exposing the firm to the risk of a hostile takeover. Moreover, with a lower stock price, it is more costly for firms to raise the required capital to fuel future growth by issuing stock.

LOWER COSTS. Firms are also motivated to grow in order to lower their cost. As discussed in detail in Chapter 6, a larger firm may benefit from *economies of scale*, thus driving down average costs as their output increases. Firms need to grow to achieve minimum efficient scale, and thus stake out the lowest-cost position achievable through economies of scale.

INCREASE MARKET POWER. Firms might be motivated to achieve growth to increase their market share and with it their market power. When discussing an industry's structure in Chapter 3, we noted that firms often consolidate industries through horizontal mergers and acquisitions (buying competitors) to change the industry structure in their favor (we'll discuss mergers and acquisitions in detail in Chapter 9). Fewer competitors generally equates to higher industry profitability. Moreover, larger firms have more bargaining power with suppliers and buyers (see the discussion of the five forces in Chapter 3).

REDUCE RISK. Firms might be motivated to grow in order to diversify their product and service portfolio through competing in a number of different industries. The rationale behind these diversification moves is that falling sales and lower performance in one sector (e.g., GE's oil and gas unit) might be compensated by higher performance in another (e.g., GE's health care unit). Such conglomerates attempt to achieve *economies of scope* (as first discussed in Chapter 6).

MOTIVATE MANAGEMENT. Firms need to grow to motivate management. Growing firms afford career opportunities and professional development for employees. Firms that achieve profitable growth can also pay higher salaries and spend more on benefits such as health care insurance for its employees and paid parental leave, among other perks.

Research in behavioral economics, moreover, suggests that firms may grow to achieve goals that benefit managers more than stockholders.⁴ As we will discuss in detail when presenting the *principal-agent problem* later in the chapter, managers may be more interested in pursuing their own interests such as empire building and job security—plus managerial perks such as corporate jets or executive retreats at expensive resorts—rather than increasing shareholder value. Although there is a weak link between CEO compensation and firm performance, the CEO pay package often correlates more strongly with firm size.⁵

Finally, we should acknowledge that promising businesses can fail because they grow unwisely—usually too fast too soon, and based on shaky assumptions about the future. There is a small movement counter to the need for growth, seen both in small businesses and social activism. Sometimes small-business owners operate a business for convenience, stability, and lifestyle; growth could threaten those goals. In social entrepreneurship, business micro-solutions are often operated outside of capital motives, where the need to solve a social problem outweighs the need of the firm to insure longevity beyond the solution of the problem.

THREE DIMENSIONS OF CORPORATE STRATEGY

All companies must navigate the three dimensions of vertical integration, diversification, and geographic scope. Although many managers provide input, the responsibility for corporate strategy ultimately rests with the CEO. Jeff Bezos, Amazon's CEO, determined in *what stages of the industry value chain Amazon would participate* (question 1). With its prevalent delivery lockers in large metropolitan areas and its first brick-and-mortar retail store opened

in New York City, Amazon moved forward in the industry value chain to be closer to its end customer. With its offering of Amazon-branded electronics and other everyday items, it also moved backward in the industry value chain toward manufacturing, production. Similarly, the creation of AWS, now the largest cloud-computing service provider globally with some 100 million customers, is a backward vertical integration move. AWS provides Amazon with back-end IT services such as website hosting, computing power, data storage and management, etc., which in turn are all critical inputs to its online retail business.

Bezos also chooses *what range of products and services to offer*, and which not to offer (question 2). The ChapterCase discusses Amazon's diversification over time. Finally, Bezos also decided to customize certain country-specific websites despite the instant global reach of ecommerce firms. With this strategic decision, he decided where to compete globally in terms of different geographies beyond the United States. In short, Bezos determined *where Amazon competes geographically* (question 3).

Where to compete in terms of industry value chain, products and services, and geography are the fundamental corporate strategic decisions. The underlying strategic management concepts that will guide our discussion of vertical integration, diversification, and geographic competition are *core competencies*, *economies of scale*, *economies of scope*, and *transaction costs*.

- *Core competencies* are unique strengths embedded deep within a firm (as discussed in Chapter 4). Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at lower cost. According to the *resource-based view of the firm*, a firm's boundaries are delineated by its knowledge bases and core competencies.⁶ Activities that draw on what the firm knows how to do well (e.g., Amazon's core competency in developing proprietary recommendation algorithms) should be done in-house, while noncore activities such as payroll and facility maintenance can be outsourced. In this perspective, the internally held knowledge underlying a core competency determines a firm's boundaries.
- *Economies of scale* occur when a firm's average cost per unit decreases as its output increases (as discussed in Chapter 6). Anheuser-Busch InBev (AB InBev), the largest global brewer (producer of some 225 brands worldwide, including famous ones such as Budweiser, Bud Light, Miller, Stella Artois, and Beck's), reaps significant economies of scale. After AB InBev merged with SABMiller in a more than \$100 billion deal in 2016, it now captures some 30 percent of global beer consumption.⁷ As a consequence of its huge scale, the beer giant captures some 50 percent of global beer profits. In terms of beer volume, the new AB InBev is also more than double the size of Heineken, the number-two competitor worldwide. Given its tremendous size, AB InBev is able to spread its fixed costs over the millions of gallons of beer it brews each year, in addition to the significant buyer power its large market share affords. Larger market share, therefore, often leads to lower costs.
- *Economies of scope* are the savings that come from producing two (or more) outputs or providing different services at less cost than producing each individually, though using the same resources and technology (as discussed in Chapter 6). Leveraging its online retailing expertise, for example, Amazon benefits from economies of scope: It can offer a large range of different product and service categories at a lower cost than it would take to offer each product line individually.
- *Transaction costs* are all costs associated with an economic exchange. Applying the logic of transaction cost economics enables managers to answer the question of whether it is cost-effective for their firm to expand its boundaries through vertical integration or diversification. This implies taking on greater ownership of the production of needed inputs or of the channels by which it distributes its outputs, or adding business units that offer new products and services.

We continue our study of corporate strategy by drawing on transaction cost economics to explain vertical integration, meaning the choices a firm makes concerning its boundaries. Later, we will explore managerial decisions relating to diversification, which directly affect the firm's range of products and services in multi-industry competition. The third question of geographic scope will receive attention later, especially in Chapter 10.

8.2 The Boundaries of the Firm

Determining the boundaries of the firm so that it is more likely to gain and sustain a competitive advantage is the critical challenge in corporate strategy.⁸ **Transaction cost economics** provides useful theoretical guidance to explain and predict the boundaries of the firm. Insights gained from transaction cost economics help strategic leaders decide what activities to do in-house versus what services and products to obtain from the external market. This stream of research was initiated by Nobel Laureate Ronald Coase, who asked a fundamental question: Given the efficiencies of free markets, why do firms even exist? The key insight of transaction cost economics is that different *institutional arrangements*—markets versus firms—have different costs attached.

Transaction costs are all internal and external costs associated with an economic exchange, whether it takes place within the boundaries of a firm or in markets.⁹ Exhibit 8.2 visualizes the notion of transaction costs. It shows the respective internal transactions costs within Firm A and Firm B, as well as the external transactions that occur when Firm A and Firm B do business with one another.

The total costs of transacting consist of external and internal transaction costs, as follows:

- When companies transact in the open market, they incur **external transaction costs**: the costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.
- Transaction costs can occur within the firm as well. Considered **internal transaction costs** these include costs pertaining to organizing an economic exchange within a firm—for example, the costs of recruiting and retaining employees; paying salaries and benefits; setting up a shop floor; providing office space and computers; and organizing,

LO 8-3

Describe and evaluate different options firms have to organize economic activity.

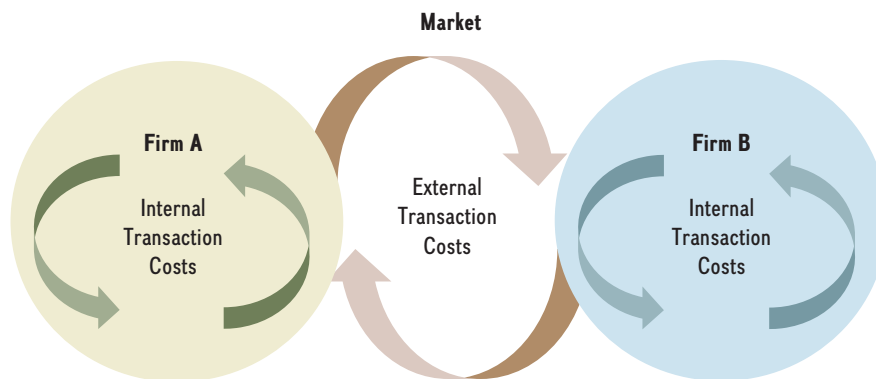


EXHIBIT 8.2

Internal and External Transaction Costs

transaction cost economics A theoretical framework in strategic management to explain and predict the boundaries of the firm, which is central to formulating a corporate strategy that is more likely to lead to competitive advantage.

transaction costs All internal and external costs associated with an economic exchange, whether within a firm or in markets.

external transaction costs Costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.

internal transaction costs Costs pertaining to organizing an economic exchange within a hierarchy; also called *administrative* costs.

monitoring, and supervising work. Internal transaction costs also include administrative costs associated with coordinating economic activity between different business units of the same corporation such as transfer pricing for input factors, and between business units and corporate headquarters including important decisions pertaining to resource allocation, among others. Internal transaction costs tend to increase with organizational size and complexity.

FIRMS VS. MARKETS: MAKE OR BUY?

Predictions derived from transaction cost economics guide strategic leaders in deciding which activities a firm should pursue in-house (“make”) versus which goods and services to obtain externally (“buy”). These decisions help determine the boundaries of the firm. In some cases, costs of using the market such as search costs, negotiating and drafting contracts, monitoring work, and enforcing contracts when necessary may be higher than integrating the activity within a single firm and coordinating it through an organizational hierarchy. When the costs of pursuing an activity in-house are less than the costs of transacting for that activity in the market ($C_{in-house} < C_{market}$), then the firm should *vertically integrate* by owning production of the needed inputs or the channels for the distribution of outputs. In other words, when *firms* are more efficient in organizing economic activity than are *markets*, which rely on contracts among many independent actors, firms should vertically integrate.¹⁰

For example, rather than contracting in the open market for individual pieces of software code, Google (a unit of Alphabet) hires programmers to write code in-house. Owning these software development capabilities is valuable to the firm because its costs, such as salaries and employee benefits to in-house computer programmers, are less than what they would be in the open market. More importantly, Google gains economies of scope in software development resources and capabilities and reduces the monitoring costs. Skills acquired in writing software code for its different internet-based service offerings are transferable to new offerings. Programmers working on the original proprietary software code for the Google search

engine leveraged these skills in creating a highly profitable online advertising business (AdWords and AdSense).¹¹ Although some of Google’s software products are open source, such as the Android operating system, many of the company’s internet services are based on closely guarded and proprietary software code. Google, like many leading high-tech companies such as Amazon, Apple, Facebook, and Microsoft, relies on proprietary software code and algorithms, because using the open market to transact for individual pieces of software would be prohibitively expensive. Also, the firms would need to disclose the underlying software code to outside developers, thus negating the value-creation potential.

Firms and markets, as different institutional arrangements for organizing economic activity, have their own distinct advantages and disadvantages, summarized in Exhibit 8.3.

EXHIBIT 8.3 Organizing Economic Activity: Firms vs. Markets

	Firm	Markets
Advantages	• Command and control - Fiat - Hierarchical lines of authority • Coordination • Transaction-specific investments • Community of knowledge	• High-powered incentives • Flexibility
Disadvantages	• Administrative costs • Low-powered incentives • Principal-agent problem	• Search costs • Opportunism - Hold-up • Incomplete contracting - Specifying & measuring performance - Information asymmetries • Enforcement of contracts

The advantages of firms include:

- The ability to make *command-and-control decisions* by fiat along clear hierarchical lines of authority.
- *Coordination* of highly complex tasks to allow for specialized division of labor.
- *Transaction-specific investments*, such as specialized robotics equipment that is highly valuable within the firm, but of little or no use in the external market.
- Creation of a *community of knowledge*, meaning employees within firms have ongoing relationships, exchanging ideas and working closely together to solve problems. This facilitates the development of a deep knowledge repertoire and ecosystem within firms. For example, scientists within a biotech company who worked together developing a new cancer drug over an extended time period may have developed group-specific knowledge and routines. These might lay the foundation for innovation, but would be difficult, if not impossible, to purchase on the open market.¹²

The disadvantages of organizing economic activity within firms include:

- *Administrative costs* because of necessary bureaucracy.
- *Low-powered incentives*, such as hourly wages and salaries. These often are less attractive motivators than the entrepreneurial opportunities and rewards that can be obtained in the open market.
- The *principal–agent problem*.

The **principal–agent problem** is a major disadvantage of organizing economic activity within firms, as opposed to within markets. It can arise when an agent such as a manager, performing activities on behalf of the principal (the owner of the firm), pursues his or her own interests.¹³ Indeed, the *separation of ownership and control* is one of the hallmarks of a publicly traded company, and so some degree of the principal–agent problem is almost inevitable.¹⁴ For example, a manager may pursue his or her own interests such as job security and managerial perks (e.g., corporate jets and golf outings) that conflict with the principal’s goals—in particular, creating shareholder value. One potential way to overcome the principal–agent problem is to give stock options to managers, thus making them owners. We will revisit the principal–agent problem, with related ideas, in Chapters 11 and 12.

principal–agent problem Situation in which an agent performing activities on behalf of a principal pursues his or her own interests.

The advantages of markets include:

- *High-powered incentives*. Rather than work as a salaried engineer for an existing firm, for example, an individual can start a new venture offering specialized software. High-powered incentives of the open market include the entrepreneur’s ability to capture the venture’s profit, to take a new venture through an initial public offering (IPO), or to be acquired by an existing firm. In these so-called *liquidity events*, a successful entrepreneur can make potentially enough money to provide financial security for life.¹⁵
- *Increased flexibility*. Transacting in markets enables those who wish to purchase goods to compare prices and services among many different providers.

The disadvantages of markets include:

- *Search costs*. On a very fundamental level, perhaps the biggest disadvantage of transacting in markets, rather than owning the various production and distribution activities within the firm itself, entails nontrivial *search costs*. In particular, a firm faces search costs when it must scour the market to find reliable suppliers from among the many firms competing to offer similar products and services. Even more difficult can be the search to find suppliers when the specific products and services needed are not offered by firms currently in the market. In this case, production of supplies would require transaction-specific investments, an advantage of firms.

- *Opportunism by other parties.* *Opportunism* is behavior characterized by self-interest seeking with guile (we'll discuss this in more detail later).
- *Incomplete contracting.* Although market transactions are based on implicit and explicit contracts, all contracts are incomplete to some extent, because not all future contingencies can be anticipated at the time of contracting. It is also difficult to specify expectations (e.g., What stipulates "acceptable quality" in a graphic design project?) or to measure performance and outcomes (e.g., What does "excess wear and tear" mean when returning a leased car?). Another serious hazard inherent in contracting is *information asymmetry* (which we discuss next).
- *Enforcement of contracts.* It often is difficult, costly, and time-consuming to enforce legal contracts. Not only does litigation absorb a significant amount of managerial resources and attention, but also it can easily amount to several million dollars in legal fees. Legal exposure is one of the major hazards in using markets rather than integrating an activity within a firm's hierarchy.

information asymmetry Situation in which one party is more informed than another because of the possession of private information.

Frequently, sellers have better information about products and services than buyers, which creates **information asymmetry**, a situation in which one party is more informed than another, because of the possession of private information. When firms transact in the market, such unequal information can lead to a *lemons problem*. Nobel Laureate George Akerlof first described this situation using the market for used cars as an example.¹⁶ Assume only two types of used cars are sold: good cars and bad cars (lemons). Good cars are worth \$8,000 and bad ones are worth \$4,000. Moreover, only the seller knows whether a car is good or is a lemon. Assuming the market supply is split equally between good and bad cars, the probability of buying a lemon is 50 percent. Buyers are aware of the general possibility of buying a lemon and thus would like to hedge against it. Therefore, they split the difference and offer \$6,000 for a used car. This discounting strategy has the perverse effect of crowding out all the good cars because the sellers perceive their value to be above \$6,000. Assuming that to be the case, all used cars offered for sale will be lemons.

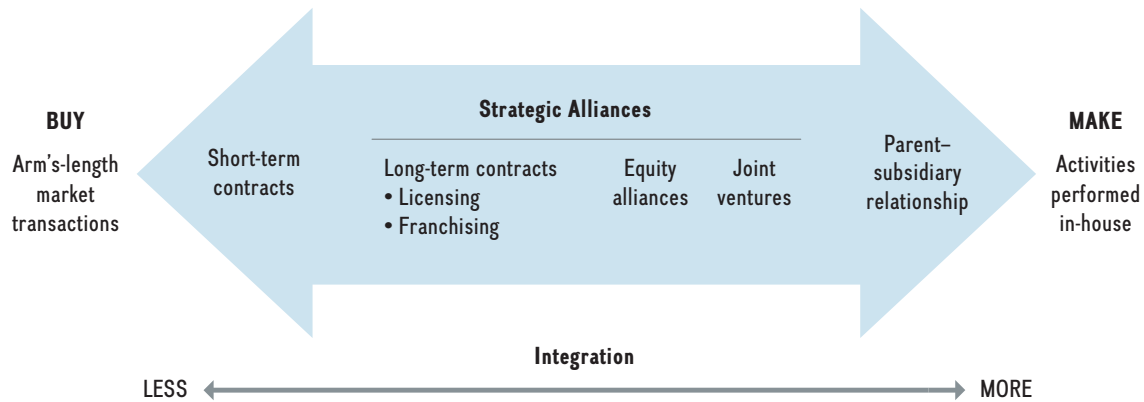
The important take-away here is *caveat emptor*—buyer beware. Information asymmetries can result in the crowding out of desirable goods and services by inferior ones. This has been shown to be true in many markets, not just for used cars, but also in ecommerce (e.g., eBay), mortgage-backed securities, and even collaborative R&D projects.¹⁷

ALTERNATIVES ON THE MAKE-OR-BUY CONTINUUM

The "make" and "buy" choices *anchor each end of a continuum* from markets to firms, as depicted in Exhibit 8.4. Several alternative hybrid arrangements are available between these two extremes.¹⁸ Moving from transacting in the market ("buy") to full integration ("make"), alternatives include short-term contracts as well as various forms of strategic alliances (long-term contracts, equity alliances, and joint ventures) and parent–subsidiary relationships.

SHORT-TERM CONTRACTS. When engaging in *short-term contracting*, a firm sends out *requests for proposals (RFPs)* to several companies, which initiates competitive bidding for contracts to be awarded with a short duration, generally less than one year.¹⁹ The benefit to this approach lies in the fact that it allows a somewhat longer planning period than individual market transactions. Moreover, the buying firm can often demand lower prices due to the competitive bidding process. The drawback, however, is that firms responding to the RFP have no incentive to make any transaction-specific investments (e.g., buy new machinery to improve product quality) due to the short duration of the contract. This is exactly what happened in the U.S. automotive



EXHIBIT 8.4 / Alternatives on the Make-or-Buy Continuum

industry when GM used short-term contracts for standard car components to reduce costs. When faced with significant cost pressures, suppliers reduced component quality in order to protect their eroding margins. This resulted in lower-quality GM cars, contributing to a competitive advantage vis-à-vis competitors, most notably Toyota but also Ford, which used a more cooperative, longer-term partnering approach with suppliers.²⁰

STRATEGIC ALLIANCES. As we move toward greater integration on the make-or-buy continuum, the next organizational forms are strategic alliances. **Strategic alliances** are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.²¹ Alliances have become a ubiquitous phenomenon, especially in high-tech industries. Moreover, strategic alliances can facilitate investments in transaction-specific assets without encountering the internal transaction costs involved in owning firms in various stages of the industry value chain.

Strategic alliances is an umbrella term that denotes different hybrid organizational forms—among them, long-term contracts, equity alliances, and joint ventures. Given their prevalence in today's competitive landscape as a key vehicle to execute a firm's corporate strategy, we take a quick look at strategic alliances here and then study them in more depth in Chapter 9.

Long-Term Contracts. We noted that firms in short-term contracts have no incentive to make transaction-specific investments. *Long-term contracts*, which work much like short-term contracts but with a duration generally greater than one year, help overcome this drawback. Long-term contracts help facilitate transaction-specific investments. **Licensing**, for example, is a form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property such as a patent. The first biotechnology drug to reach the market, Humulin (human insulin), was developed by Genentech and commercialized by Eli Lilly based on a licensing agreement.

In service industries, **franchising** is an example of long-term contracting. In these arrangements, a franchisor, such as McDonald's, Burger King, 7-Eleven, H&R Block, or Subway, grants a franchisee (usually an entrepreneur owning no more than a few outlets) the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name. Besides providing the capital to finance the expansion of the chain, the franchisee generally pays an up-front (buy-in) lump sum to the franchisor plus a percentage of revenues.

strategic alliances

Voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

licensing A form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property.

franchising A long-term contract in which a franchisor grants a franchisee the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name.

Equity Alliances. Yet another form of strategic alliance is an *equity alliance*—a partnership in which at least one partner takes partial ownership in the other partner. A partner purchases an ownership share by buying stock or assets (in private companies), and thus making an equity investment. The taking of equity tends to signal greater commitment to the partnership. Strategy Highlight 8.1 describes how soft drink giant Coca-Cola Co. formed an equity alliance with energy-drink maker Monster.

Why is the Coca-Cola Co. forming an equity alliance with Monster Beverage Corp. and not just entering a short- or long-term contract, such as a distribution and profit-sharing agreement? One reason is that an equity investment in Monster might give Coca-Cola an inside look into the company. Gaining more information could be helpful if Coca-Cola decides to acquire Monster in the future. Gaining such private information might not be possible with a mere contractual agreement. Buying time is also helpful so Coca-Cola Co. can see how the wrongful death lawsuits play out, and thus limit the potential downside to Coke's wholesome brand image (as mentioned in Strategy Highlight 8.1).

Strategy Highlight 8.1

Is Coke Becoming a Monster?

While Americans are drinking ever more nonalcoholic beverages, the demand for longtime staples such as the full-calorie Coke or Pepsi are in free fall. More health-conscious consumers are moving away from sugary drinks at the expense of Coke and Pepsi, the two archrivals among regular colas. Unlike in the 1990s, however, Americans are not replacing them with diet sodas, but rather with bottled water and energy drinks. Indeed, Coca-Cola was slow to catch the trend toward bottled water and other more healthy choices such as vitamin water. Protecting its wholesome image, the conservative Coca-Cola Co. shunned energy drinks. The makers of energy drinks, such as 5-hour Energy, Red Bull, Monster, Rockstar, and Amp Energy, have faced wrongful death lawsuits. PepsiCo, on the other hand, was much more aggressive in moving into the energy-drink business with Amp Energy (owned by PepsiCo) and Rockstar (distributed by PepsiCo).

Albeit late to the party, Coca-Cola decided to not miss out completely on energy drinks, one of the fastest-growing segments in nonalcoholic beverages. After years of deliberation, in 2014 the Coca-Cola Co. formed an equity alliance with Monster Beverage Corp., spending \$2 billion for a 16.7 percent stake in the edgy energy-drink company. This values the privately held Monster Beverage at roughly \$12 billion. What might have finally persuaded Coca-Cola to make this decision? Not only was Monster now number one with 40 percent market share of the over \$6 billion energy-drink industry, but

the company also had settled a number of wrongful death lawsuits out of court. Meanwhile, however, the U.S. Food and Drug Administration is still investigating some 300 “adverse event” reports allegedly linked to the consumption of energy drinks, including 31 deaths. While the Coca-Cola Co. insists that it completed its due diligence before concluding that energy drinks are safe, it hedges its bets with a minority investment in Monster rather than an outright acquisition. This allows the market leader in nonalcoholic beverages to benefit from the explosive growth in energy drinks, while limiting potential exposure of Coca-Cola's wholesome image and brand. Meanwhile, Monster paid about \$20 million to sponsor NASCAR's top racing series in 2017.²²



The Coca-Cola Co. holds an ownership stake through an equity alliance in the Monster Beverage Corp., which sponsors the NASCAR top racing series. ©Chris Graythen/Getty Images Sport/Getty Images

Moreover, in strategic alliances based on a mere contractual agreement, one transaction partner could attempt to *hold up* the other by demanding lower prices or threatening to walk away from the agreement (with whatever financial penalties might be included in the contract). This might be a real concern for Monster because Coca-Cola, with about \$50 billion in annual sales, is about 20 times larger than Monster with \$2.5 billion in revenues. To assuage Monster's concerns, with its equity investment, Coca-Cola made a **credible commitment**—a long-term strategic decision that is both difficult and costly to reverse.

Joint Ventures. In a **joint venture**, which is another special form of strategic alliance, two or more partners create and jointly own a new organization. Since the partners contribute equity to a joint venture, they make a long-term commitment, which in turn facilitates transaction-specific investments. Dow Corning, initially created and owned jointly by Dow Chemical and Corning, is an example of a joint venture. Dow Corning focuses on silicone-based technology and employs roughly 10,000 people with \$5 billion in annual revenues. That success shows that some joint ventures can be quite large.²³ Since 2017, Dow Corning is now owned by DowDuPont, after Dow Chemical and DuPont merged, creating a chemical-agricultural giant with some \$120 billion in annual sales.

Hulu, a subscription video-on-demand service, is also a joint venture, owned NBCUniversal, Fox, Disney-ABC, and Turner Broadcasting System (TBS). In the United States, Hulu, with some 12 million subscribers in 2017, is a smaller competitor to Netflix (50 million) and to Amazon Prime with its 65 million members.²⁴

PARENT-SUBSIDIARY RELATIONSHIP. The *parent–subsidiary relationship* describes the most-integrated alternative to performing an activity within one's own corporate family (and thus anchors the make-or-buy continuum in Exhibit 8.4 on the “make” side). The corporate parent owns the subsidiary and can direct it via command and control. Transaction costs that arise are frequently due to political turf battles, which may include the capital budgeting process and transfer prices, among other areas. Other areas of potential conflict concern how centralized or decentralized a subsidiary unit should be run.

For example, although GM owned its European carmakers (Opel in Germany and Vauxhall in the United Kingdom), it had problems bringing some of their know-how and design of small fuel-efficient cars back into the United States. This failure put GM at a competitive disadvantage vis-à-vis the Japanese competitors when they were first entering the U.S. market with more fuel-efficient cars. In addition, the Japanese carmakers were able to improve the quality and design of their vehicles faster, which enabled them to gain a competitive advantage, especially in an environment of rising gas prices.

The GM versus Opel and Vauxhall parent–subsidiary relationship was burdened by political problems because managers in Detroit did not respect the engineering behind the small, fuel-efficient cars that Opel and Vauxhall made. They were not interested in using European know-how for the U.S. market and didn't want to pay much or anything for it. Moreover, Detroit was tired of subsidizing the losses of Opel and Vauxhall, and felt that its European subsidiaries were manipulating the capital budgeting process.²⁵ In turn, the Opel and Vauxhall subsidiaries felt resentment toward their parent company: GM had threatened to shut them down as part of its bankruptcy restructuring, whereas they instead hoped to be divested as independent companies.²⁶

credible commitment

A long-term strategic decision that is both difficult and costly to reverse.

joint venture

A stand-alone organization created and jointly owned by two or more parent companies.



GM CEO Mary Barra divested both Opel and Vauxhall by selling the GM subsidiaries to Peugeot, a French carmaker. Over many years the conflict in the parent–subsidiary relationship between GM and its European units shows that even the most integrated form of corporate relationships can be prone to high transaction costs.

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News/Getty Images

After many years of acrimonious parent–subsidiary relationships, GM sold Opel and Vauxhall to Peugeot, a French carmaker, for a bit over \$2 billion in 2017.²⁷ This marks GM’s exit from the European car market, which has been a notorious money-losing venture for the Detroit automaker. Europe is one of the most competitive automobile markets in the world, and home to several strong car brands. The European market also is consistently plagued by excess capacity because of fickle consumer tastes. Rather than focusing on being the world’s largest carmaker in terms of volume, GM CEO Mary Barra is now focusing more on profitability. In contrast to Europe, GM is much stronger in its home market and highly profitable, especially in large pickup trucks and SUVs. Divesting its European operations also allows Barra to focus the Detroit-based carmaker more on growth markets in Asia, especially in China, where GM holds a strong position, with Shanghai GM Co., the 50-50 joint venture between GM and SAIC Motor Corp., a Chinese carmaker.

Having laid a strong theoretical foundation by fully considering transaction cost economics and the boundaries of the firm, we now turn our attention to the firm’s position along the vertical industry value chain.

vertical integration

The firm’s ownership of its production of needed inputs or of the channels by which it distributes its outputs.

industry value chain

Depiction of the transformation of raw materials into finished goods and services along distinct vertical stages, each of which typically represents a distinct *industry* in which a number of different firms are competing.

8.3 Vertical Integration along the Industry Value Chain

The first key question when formulating corporate strategy is: In what stages of the industry value chain should the firm participate? Deciding whether to make or buy the various activities in the industry value chain involves the concept of vertical integration.

Vertical integration is the firm’s ownership of its production of needed inputs or of the channels by which it distributes its outputs. Vertical integration can be measured by a firm’s value added:

- *What percentage of a firm’s sales is generated within the firm’s boundaries?*²⁸ The degree of vertical integration tends to correspond to the number of industry value chain stages in which a firm directly participates.

EXHIBIT 8.5 / Backward and Forward Vertical Integration along an Industry Value Chain

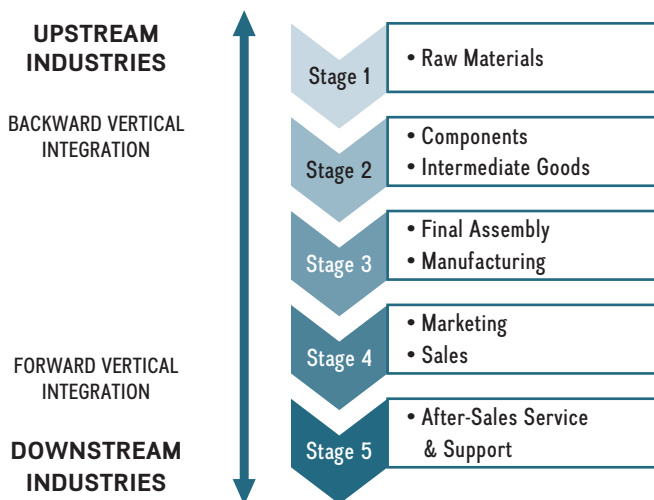


Exhibit 8.5 depicts a generic **industry value chain**. Industry value chains are also called *vertical value chains*, because they depict the transformation of raw materials into finished goods and services along distinct vertical stages. Each stage of the vertical value chain typically represents a distinct *industry* in which a number of different firms are competing. This is also why the expansion of a firm up or down the *vertical* industry value chain is called *vertical* integration.

To explain the concept of vertical integration along the different stages of the industry value chain more fully, let’s use your cell phone as an example. This ubiquitous device is the result of a globally coordinated industry value chain of different products and services:

- *Stage 1: Raw Materials.* The raw materials to make your cell phone, such as chemicals, ceramics, metals, oil for plastic, and so on,

are commodities. In each of these commodity businesses are different companies, such as DuPont (United States), BASF (Germany), Kyocera (Japan), and ExxonMobil (United States).

- *Stage 2: Intermediate Goods and Components.* Elements such as integrated circuits, displays, touchscreens, cameras, and batteries are provided by firms such as ARM Holdings (United Kingdom), Jabil (United States), Intel (United States), LG Display (Korea), Altek (Taiwan), and BYD (China).
- *Stage 3: Final Assembly and Manufacturing.* Original equipment manufacturing firms (OEMs) such as Flextronics (Singapore) or Foxconn (China) typically assemble cell phones under contract for consumer electronics and telecommunications companies such as Apple (United States), Samsung and LG (both South Korea), Huawei and Oppo Electronics (both China), and others. If you look closely at an iPhone, for example, you'll notice it says, "Designed by Apple in California. Assembled in China."
- *Stages 4 and 5: Marketing, Sales, After-Sales Service, Support.* Finally, to get wireless data and voice service, you pick a service provider such as AT&T, Sprint, T-Mobile, or Verizon in the United States; América Móvil in Mexico; Oi in Brazil; Orange in France; T-Mobile or Vodafone in Germany; NTT Docomo in Japan; Airtel in India; or China Mobile in China, among others. In 2015, Google launched a low-cost wireless service in the United States. Called Project Fi, the wireless service plans offered by Google cost \$20 a month for talk and text, including Wi-Fi and international coverage. Each gigabyte of data costs \$10 per month. Google's goal is that by providing lower-priced wireless services, more people will connect to the internet, which means more demand for its core online search business and ad-supported YouTube video service. On the downside, initially it is available only with Google phones such as the Pixel.²⁹

All of these companies—from the raw-materials suppliers to the service providers—make up the global industry value chain that, as a whole, delivers you a working cell phone. Determined by their corporate strategy, each firm decides where in the industry value chain to participate. This in turn defines the vertical boundaries of the firm.

TYPES OF VERTICAL INTEGRATION

Along the industry value chain, firms pursue varying degrees of vertical integration in their corporate strategy. Some firms participate in only one or a few stages of the industry value chain, while others comprise many if not all stages. In general, fewer firms are fully vertically integrated. Most firms concentrate on only a few stages in the industry value chain, and some firms just focus on one. The following examples illuminate different degrees of vertical integration along the industry value chain.

E&J Gallo Winery is the world's largest family-owned winery. With sales in some 90 countries, it is also the largest exporter of California wines. As a fully vertically integrated producer and distributor, it participates in all stages of the industry value chain. E&J Gallo's corporate strategy and resulting activities along the industry value chain are guided by the mantra "from grape to glass." E&J Gallo owns its own vineyards, bottling

LO 8-4

Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.



E&J Gallo, the California winery, is fully vertically integrated, following its corporate strategy mantra "from grape to glass." E&J Gallo is also the largest exporter of California wines.

©Sherri Camp/123RF

plants, distribution and logistics network, and retails via the internet where allowed. (Some states in the United States ban direct-to-consumer sale of alcoholic beverages.)

Being fully vertically integrated allows E&J Gallo to achieve *economies of scale*, resulting in lower cost. Additional operational efficiency is achieved by effective coordination such as scheduling along the industry value chain. E&J Gallo also emphasizes that being fully vertically integrated allows it to control quality better and to provide the end user with a better experience. Offering a house of brands, consisting of many different wines at different price points, also allows E&J Gallo to differentiate its product and to reap economies of scope. E&J Gallo's value added approaches 100 percent. The California winery, therefore, competes in a number of different industries along the entire vertical value chain. As a consequence, it faces different competitors in each stage of the industry value chain, both domestically and internationally.

On the other end of the spectrum are firms that are more or less vertically disintegrated with a low degree of vertical integration. These firms focus on only one or a few stages of the industry value chain. Apple, for example, focuses only on design, marketing, and retailing; all other value chain activities are outsourced.

Be aware that not all industry value chain stages are equally profitable. Apple captures significant value by designing mobile devices through integration of hardware and software in novel ways, but it outsources the manufacturing to generic OEMs. The logic behind these decisions can be explained by applying Porter's five forces model and the VRIO model. The many small cell phone OEMs are almost completely interchangeable and are exposed to the perils of perfect competition. However, Apple's competencies in innovation, system integration, and marketing are valuable, rare, and unique (non-imitable) resources, and Apple is organized to capture most of the value it creates. Apple's continued innovation through new products and services provides it with a string of temporary competitive advantages.

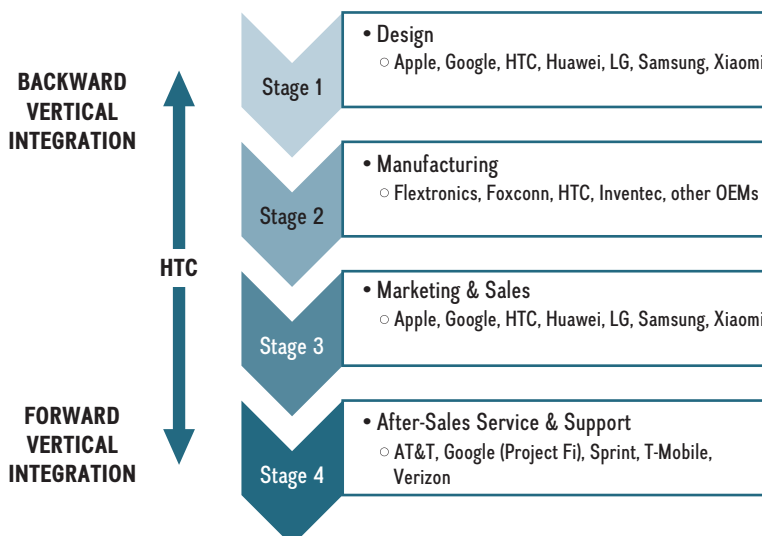
Exhibit 8.6 displays part of the industry value chain for smartphones. In this figure, note HTC's transformation from a no-name OEM manufacturer in stage 2 of the vertical value chain to a player in the design, manufacture, and sale of smartphones (stages 1 and 3). It now offers a lineup of innovative and high-performance smartphones under the HTC label.³⁰

Firms regularly start out as OEMs and then vertically integrate along the value chain in either a backward and/or forward direction. With these moves, former contractual partners to brand-name phone makers such as Apple and Samsung then become their competitors. OEMs are able to vertically integrate because they acquire the skills needed to compete in adjacent industry value chain activities from their alliance partners, which need to share the technology behind their proprietary phone to enable large-scale manufacturing.

Over time, HTC was able to upgrade its capabilities from merely manufacturing smartphones to also designing products.³¹ In doing so, HTC engaged in **backward vertical integration**—moving ownership of activities upstream to the originating inputs of the value chain. Moreover,

backward vertical integration Changes in an industry value chain that involve moving ownership of activities upstream to the originating (inputs) point of the value chain.

EXHIBIT 8.6 / HTC's Backward and Forward Integration along the Industry Value Chain in the Smartphone Industry



by moving downstream into sales and increasing its branding activities, HTC has also engaged in **forward vertical integration**—moving ownership of activities closer to the end customer. Although HTC has long benefited from *economies of scale* as an OEM, it is now also benefiting from *economies of scope* through participating in different stages of the industry value chain. For instance, it now can share competencies in product design, manufacturing, and sales, while at the same time attempting to reduce transaction costs.

Although, HTC with some 9 percent market share in the smartphone industry (in 2011) was the third largest handset maker—just behind Samsung and Apple—the Taiwanese smartphone has fallen on hard times since. By 2017, HTC’s market share had plummeted to less than 1 percent. New technology firms from China such as Huawei, Oppo, Vivo, and Xiaomi performed better than HTC. Yet, HTC’s vertical integration into design as well as manufacturing and sales and marketing of smartphones allowed it build a core competency that Google, a unit of Alphabet found valuable. Google contracted HTC to design and build its new high-end phone (the Pixel) for the California-based high-tech company. In 2017, Google acquired HTC’s smartphone engineering group for \$1.1 billion. Integrating HTC’s smartphone unit within Google will allow engineers to more tightly integrate hardware and software. This in turn will allow Google to differentiate its high-end Pixel phone more from the competition, especially Apple’s newly released iPhone X and Samsung’s Galaxy 8 line of phone, including the Note 8. Even though HTC by itself lost out to Samsung, Apple, and a handful of new Chinese firms in the highly competitive smartphone industry, vertical integration along the industry value chain allowed HTC to build a core competency in the design and manufacturing of smartphones for which Google paid over \$1 billion to acquire, and thus to integrate it more fully with its Android group that develops the software for Google’s mobile operating system.

Likewise, Foxconn, Apple’s largest OEM, is also vertically integrating along the industry value chain.³² In 2016, it purchased the struggling Japanese electronics manufacturer Sharp for some \$4 billion. Sharp is known for its high-quality display panels (used in smartphones and elsewhere) as well as other innovative consumer electronics such as microwave ovens and air purifiers.

Foxconn hopes to move upmarket by leveraging Sharp’s strong brand name, and to benefit from the Japanese high-tech company’s efforts to produce organic light-emitting diode (OLED) displays. Similarly to HTC, Foxconn is moving backward in the industry value chain into design of consumer electronics and forward into marketing and sales by using the Sharp brand. This shows that OEMs, over time, tend to acquire skills, know-how, and ambition to move beyond mere manufacturing, where profit margins are often razor thin.

forward vertical integration Changes in an industry value chain that involve moving ownership of activities closer to the end (customer) point of the value chain.

BENEFITS AND RISKS OF VERTICAL INTEGRATION

To decide the degree and type of vertical integration to pursue, strategic leaders need to understand the possible benefits and risks of vertical integration. At a minimum, they need to proceed with caution, and carefully consider the countervailing risks at the same time they consider the benefits.

LO 8-5

Identify and evaluate benefits and risks of vertical integration.

BENEFITS OF VERTICAL INTEGRATION. Vertical integration, either backward or forward, can have a number of benefits, including³³

- Lowering costs.
- Improving quality.
- Facilitating scheduling and planning.
- Facilitating investments in specialized assets.
- Securing critical supplies and distribution channels.

As noted earlier, HTC started as an OEM for brand-name mobile device companies such as Motorola and Nokia (both defunct) and telecom service providers AT&T and T-Mobile. More recently, HTC has been manufacturing phones for Google (which uses Motorola's patents after its acquisition of Motorola; the handset-making unit of Motorola was sold later by Google to Lenovo, a Chinese computer company). HTC backwardly integrated into smartphone design by acquiring One & Co., a San Francisco-based design firm.³⁴ The acquisition allowed HTC to secure scarce design talent and capabilities that it leveraged into the design of smartphones with superior quality and features, enhancing the differentiated appeal of its products. Moreover, HTC can now design phones that leverage its low-cost manufacturing capabilities.

Likewise, forward integration into distribution and sales allows companies to more effectively plan for and respond to changes in demand. HTC's forward integration into sales enables it to offer its products directly to wireless providers such as AT&T, Sprint, and Verizon. HTC even offers unlocked phones directly to the end consumer via its own website. With ownership and control of more stages of the industry value chain, HTC is now in a much better position to respond if, for example, demand for its latest phone should suddenly pick up.

Vertical integration along the industry value chain can also facilitate *investments in specialized assets*. What does this mean? **Specialized assets** have a high opportunity cost: They have significantly more value in their intended use than in their next-best use.³⁵ They can come in several forms.³⁶

specialized assets

Unique assets with high opportunity cost: They have significantly more value in their intended use than in their next-best use. They come in three types: site specificity, physical-asset specificity, and human-asset specificity.

- *Site specificity*—assets required to be co-located, such as the equipment necessary for mining bauxite and aluminum smelting.
- *Physical-asset specificity*—assets whose physical and engineering properties are designed to satisfy a particular customer. Examples include the bottling machinery for E&J Gallo. Given the many brands of wine offered by E&J Gallo, unique equipment, such as molds and a specific production process, is required to produce the different and trademarked bottle shapes.
- *Human-asset specificity*—investments made in human capital to acquire unique knowledge and skills, such as mastering the routines and procedures of a specific organization, which are not transferable to a different employer.

Investments in specialized assets tend to incur high opportunity costs because making the specialized investment opens up the threat of opportunism by one of the partners. *Opportunism* is defined as self-interest seeking with guile.³⁷ Backward vertical integration is often undertaken to overcome the threat of opportunism and to secure key raw materials.

In an effort to secure supplies and reduce the costs of jet fuel, Delta was the first airline to acquire an oil refinery. In 2012, it purchased a Pennsylvania-based facility from ConocoPhillips. Delta estimates that this backward vertical integration move not only will allow it to provide 80 percent of its fuel internally, but will also save it some \$300 million in costs annually. Fuel costs are quite significant for airlines; for Delta, they are some 40 percent of its total operating cost.³⁸

RISKS OF VERTICAL INTEGRATION. It is important to note that the risks of vertical integration can outweigh the benefits. Depending on the situation, vertical integration has several risks, some of which directly counter the potential benefits, including³⁹

- Increasing costs.
- Reducing quality.
- Reducing flexibility.
- Increasing the potential for legal repercussions.

A higher degree of vertical integration can lead to increasing costs for a number of reasons. In-house suppliers tend to have higher cost structures because they are not exposed to market competition. Knowing there will always be a buyer for their products reduces their incentives to lower costs. Also, suppliers in the open market, because they serve a much larger market, can achieve economies of scale that elude in-house suppliers. Organizational complexity increases with higher levels of vertical integration, thereby increasing administrative costs such as determining the appropriate transfer prices between an in-house supplier and buyer. Administrative costs are part of internal transaction costs and arise from the coordination of multiple divisions, political maneuvering for resources, the consumption of company perks, or simply from employees slacking off.

The knowledge that there will always be a buyer for their products not only reduces the incentives of in-house suppliers to lower costs, but also can reduce the incentive to increase quality or come up with innovative new products. Moreover, given their larger scale and greater exposure to more customers, external suppliers often can reap higher learning and experience effects and so develop unique capabilities or quality improvements.

A higher degree of vertical integration can also reduce a firm's strategic flexibility, especially when faced with changes in the external environment such as fluctuations in demand and technological change.⁴⁰ For instance, when technological process innovations enabled significant improvements in steelmaking, mills such as U.S. Steel and Bethlehem Steel were tied to their fully integrated business models and were thus unable to switch technologies, leading to the bankruptcy of many integrated steel mills. Non-vertically integrated mini-mills such as Nucor and Chaparral, on the other hand, invested in the new steelmaking process and grew their business by taking market share away from the less flexible integrated producers.⁴¹

U.S. regulators such as the Federal Trade Commission (FTC) and the Justice Department (DOJ) tend to allow vertical integration, arguing that it generally makes firms more efficient and lowers costs, which in turn can benefit customers. However, due to monopoly concerns, vertical integration has not gone entirely unchallenged.⁴² Before engaging in vertical integration, therefore, strategic leaders need to be aware that this corporate strategy can increase the potential for legal repercussions.

Amazon.com, featured in the ChapterCase, is facing potential legal repercussions because of its increasing scale and scope. Amazon now accounts for roughly one-half of all internet retail spending in the United States. In addition, with AWS, physical retail stores, and drone deliveries, Amazon is increasingly becoming a fully vertically integrated enterprise. Many argue that Amazon is much like a utility, providing the backbone for internet commerce, both in the business-to-consumer (B2C) as well as in the business-to-business (B2B) space. This paints a future picture in which rivals are depending more and more on Amazon's products and services to conduct their own business. Amazon's tremendous scale and scope can bring it increasingly into conflict with governments. Antitrust enforcers such as the Department of Justice might train their sights on Amazon.

WHEN DOES VERTICAL INTEGRATION MAKE SENSE?

U.S. business saw a number of periods of higher than usual vertical integration, and looking back may reveal useful lessons on how a company can make better decisions around its corporate strategy.⁴³

In the early days of automobile manufacturing, Ford Motor Co. was frustrated by shortages of raw materials and the limited delivery of parts suppliers. In response, Henry Ford decided to own the whole supply chain, so his company soon ran mining operations, rubber plantations, freighters, blast furnaces, glassworks, and its own parts manufacturer. In Ford's River Rouge plant, raw materials entered on one end, new cars rolled out the other

end. But over time, the costs of vertical integration caught up, both financial costs that undid earlier cost savings and operational costs that hampered the manufacturer's flexibility to respond to changing conditions. Indeed, Ford experienced diseconomies of scale (see Exhibit 6.5) due to its level of vertical integration and the unwieldy size of its huge plants.

In the 1970s, the chipmakers and the manufacturers of electronic products tried to move into each others' business. Texas Instruments went downstream into watches and calculators. Bowmar, which at first led the calculator market, tried to go upstream into chip manufacturing and failed. The latter 2000s saw a resurgence of vertical integration. In 2009, General Motors was trying to reacquire Delphi, a parts supplier that it had sold in 1997. In the 2010s, PepsiCo and Coca-Cola, the two major soft drink companies, purchased bottling plants (and later divested them again).

Rita McGrath suggested that the siren call of vertical integration looms large for companies seeking to completely change the customer's experience: "An innovator who can figure out how to eliminate annoyances and poor interfaces in the chain can build an incredible advantage, based on the customers' desire for that unique solution."⁴⁴ So what should company executives do as they contemplate a firm's corporate strategy? As far back as the 1990s, the consulting firm McKinsey was counseling clients that firms had to consider carefully *why* they were looking at integrating along their industry value chain. McKinsey identified the main reason to vertically integrate: failure of vertical markets.

Vertical market failure occurs when transactions within the industry value chain are too risky, and alternatives to integration are too costly or difficult to administer. This recommendation corresponds with the one derived from transaction cost economics earlier in this chapter. When discussing research on vertical integration, *The Economist* concluded, "Although reliance on [external] supply chains has risks, owning parts of the supply chain can be riskier—for example, few clothing-makers want to own textile factories, with their pollution risks and slim profits." The findings suggest that when a company vertically integrates two or more steps away from its core competency, it fails two-thirds of the time.⁴⁵

The risks of vertical integration and the difficulty of getting it right bring us to look at alternatives that allow companies to gain some of the benefits of vertical integration without the risks of full ownership of the supply chain.

vertical market failure

When the markets along the industry value chain are too risky, and alternatives too costly in time or money.

LO 8-6

Describe and examine alternatives to vertical integration.

ALTERNATIVES TO VERTICAL INTEGRATION

Ideally, one would like to find alternatives to vertical integration that provide similar benefits without the accompanying risks. Taper integration and strategic outsourcing are two such alternatives.

taper integration

A way of orchestrating value activities in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.

TAPER INTEGRATION. One alternative to vertical integration is **taper integration**. It is a way of orchestrating value activities in which a firm is backwardly integrated, but it also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.⁴⁶ Exhibit 8.7 illustrates the concept of taper integration along the vertical industry value chain. Here, the firm sources intermediate goods and components from in-house suppliers as well as outside suppliers. In a similar fashion, a firm sells its products through company-owned retail outlets and through independent retailers. Both Apple and Nike, for example, use taper integration: They own retail outlets but also use other retailers, both the brick-and-mortar type and online.

Taper integration has several benefits:⁴⁷

- It exposes in-house suppliers and distributors to market competition so that performance comparisons are possible. Rather than hollowing out its competencies by relying too much on outsourcing, taper integration allows a firm to retain and

fine-tune its competencies in upstream and downstream value chain activities.⁴⁸

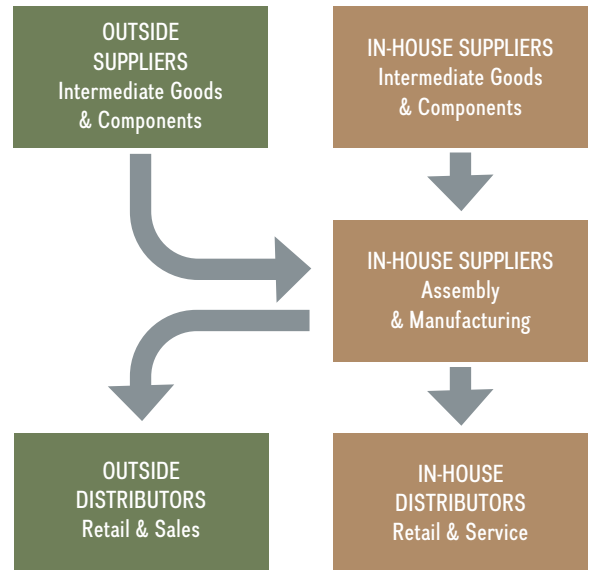
- Taper integration also enhances a firm's flexibility. For example, when adjusting to fluctuations in demand, a firm could cut back on the finished goods it delivers to external retailers while continuing to stock its own stores.
- Using taper integration, firms can combine internal and external knowledge, possibly paving the path for innovation.

Based on a study of 3,500 product introductions in the computer industry, researchers have provided empirical evidence that taper integration can be beneficial.⁴⁹ Firms that pursued taper integration achieved superior performance in both innovation and financial performance when compared with firms that relied more on vertical integration or strategic outsourcing.

STRATEGIC OUTSOURCING. Another alternative to vertical integration is **strategic outsourcing**, which involves moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain. A firm that engages in strategic outsourcing reduces its level of vertical integration. Rather than developing their own human resource management systems, for instance, firms outsource these noncore activities to companies such as PeopleSoft (owned by Oracle), EDS (owned by HP), or Perot Systems (owned by Dell), which can leverage their deep competencies and produce scale effects.

In the popular media and in everyday conversation, you may hear the term *outsourcing* used to mean sending jobs out of the country. Actually, when outsourced activities take place outside the home country, the correct term is *offshoring* (or *offshore outsourcing*). For example, Infosys, one of the world's largest technology companies and providers of IT services to many Fortune 100 companies, is located in Bangalore, India. The global offshoring market for services peaked at more than \$1 trillion in 2015, but has since been declining somewhat.⁵⁰ Banking and financial services, IT, and health care are the most active sectors in such offshore outsourcing. More recently, U.S. law firms began to off-shore low-end legal work, such as drafting standard contracts and background research, to India.⁵¹ We discuss *global strategy* in detail in Chapter 10.

EXHIBIT 8.7 / Taper Integration along the Industry Value Chain



strategic outsourcing Moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain.

8.4 Corporate Diversification: Expanding Beyond a Single Market

Early in the chapter, we listed three questions related to corporate strategy and, in particular, the boundaries of the firm. We discussed the first question of defining corporate strategy in detail:

1. *Vertical integration: In what stages of the industry value chain should the firm participate?*

We explored this question primarily in terms of firm boundaries based on the *degree of vertical integration*. We now turn to the second and third questions that determine corporate strategy and the boundaries of the firm.

2. *Product diversification: What range of products and services should the firm offer?*

The second question relates to the firm's *degree of product diversification*: What range of products and services should the firm offer? In particular, why do some companies compete in a single product market, while others compete in several different product markets? Coca-Cola, for example, focuses on soft drinks and thus on a *single* product market. Its archrival PepsiCo competes directly with Coca-Cola by selling a wide variety of soft drinks and other beverages, and also offering different types of chips such as Lay's, Doritos, and Cheetos, as well as Quaker Oats products such as oatmeal and granola bars. Although PepsiCo is more diversified than Coca-Cola, it has reduced its level of diversification in recent years.

3. *Geographic diversification: Where should the firm compete in terms of regional, national, or international markets?*

The third and final of the key questions concerns the question of *where to compete* in terms of regional, national, or international markets. This decision determines the firm's *degree of geographic diversification*. For example, why do some firms compete beyond state boundaries, while others are content to focus on the local market? Why do some firms compete beyond their national borders, while others prefer to focus on the domestic market?

Kentucky Fried Chicken (KFC), the world's largest quick-service chicken restaurant chain, operates 20,000 outlets in some 120 countries.⁵² Interestingly, KFC has more restaurants in China with over 5,000 outlets than in the United States, its birthplace, with some 4,500 outlets. Of course, China has 1.4 billion people and the United States has a mere 320 million. PepsiCo CEO Indra Nooyi was instrumental in spinning out KFC, as well as Pizza Hut and Taco Bell, to reduce PepsiCo's level of diversification. In 1997, the three fast food chains were established as an independent company under the name Yum Brands. In 2014, Yum Brands annual revenues were \$13 billion. In 2016, after being pressured by activist investors, Yum Brands sold a stake in its China operation to Alibaba Group (a Chinese internet conglomerate) and an individual Chinese investor. (After spinning out its China operation, the remaining Yum Brands had annual revenues of \$4.2 billion.)⁵³ The activist investors argued that Yum's China operation was really the crown jewel in Yum Brand's portfolio, and that more value for shareholders would be unlocked if the China operation would be managed as a standalone unit, rather than being part of the geographically diversified Yum Brands.⁵⁴

Compare KFC, active in 120 countries across the globe, with the privately held Chick-fil-A, the world's second-largest quick-service chicken restaurant.⁵⁵ KFC and Chick-fil-A are direct competitors in the United States, both specializing in chicken in the fast food market. But Chick-fil-A operates only in the United States; by 2016 it had some 2,100 locations across 45 states and earned \$6 billion in sales.⁵⁶

Why are KFC and Chick-fil-A pursuing different corporate strategies? Although both companies were founded roughly during the same time period (KFC in 1930 and Chick-fil-A in 1946), one big difference between KFC and Chick-fil-A is the ownership structure. KFC is a publicly traded stock company, as part of Yum Brands (stock ticker symbol: YUM) and Yum China (traded under YUMC, also on the New York Stock Exchange). Chick-fil-A, in contrast, is privately owned. Indeed, the privately owned Chick-fil-A is one of the largest family-owned businesses in the United States.

Public companies are often expected by shareholders to achieve profitable growth to result in an appreciation of the stock price and thus an increase in shareholder value (see the discussion in Chapter 5). That is also the reason Yum's China operation was spun off from Yum Brands, because it is performing much better. In addition, investors were

concerned that the lower-performing units at Yum Brands (e.g., KFC in the United States) would continue to be subsidized by the higher-performing China unit.

In contrast, private companies generally grow slower than public companies because their growth is mostly financed through retained earnings and debt rather than equity. Before an initial public offering, private companies do not have the option to sell shares (equity) to the public to fuel growth. This is one explanation why KFC focuses on international markets, especially China, where future expected growth continues to be high, while Chick-fil-A focuses on the domestic U.S. market. KFC is geographically diversified, while Chick-fil-A is not.

Answers to questions about the number of markets to compete in and where to compete geographically relate to the broad topic of **diversification**. A firm that engages in diversification increases the variety of products and services it offers or markets and the geographic regions in which it competes. A *non-diversified company* focuses on a single market, whereas a *diversified company* competes in several different markets simultaneously.⁵⁷

There are various general diversification strategies:

- A firm that is active in several different product markets is pursuing a **product diversification strategy**.
- A firm that is active in several different countries is pursuing a **geographic diversification strategy**.
- A company that pursues *both* a product *and* a geographic diversification strategy simultaneously follows a **product–market diversification strategy**.

Because shareholders expect continuous growth from public companies, strategic leaders frequently turn to product and geographic diversification to achieve it. It is therefore not surprising that the vast majority of the Fortune 500 companies are diversified to some degree. Achieving performance gains through diversification, however, is not guaranteed. Some forms of diversification are more likely to lead to performance improvements than others. We now discuss which diversification types are more likely to lead to a competitive advantage, and why.

TYPES OF CORPORATE DIVERSIFICATION

To understand the different types and degrees of corporate diversification, Richard Rumelt developed a helpful classification scheme that identifies four main types of diversification by identifying two key variables:⁵⁸

- The *percentage of revenue* from the dominant or primary business.
- The *relationship of the core competencies* across the business units.

Note that this classification scheme concerns product markets, and not geographic diversification. Knowing the percentage of revenue of the dominant business (the first variable), lets us identify the first two types of diversification: *single business* and *dominant business*. Asking questions about the relationship of core competencies across business units allows us to identify the other two types: *related diversification* and *unrelated diversification*. Taken together, the four main types of business diversification are

1. Single business.
2. Dominant business.
3. Related diversification.
4. Unrelated diversification: the conglomerate.

Please note that related diversification (type 3) is divided into two subcategories. We discuss each type of diversification below.

diversification An increase in the variety of products and services a firm offers or markets and the geographic regions in which it competes.

product diversification strategy Corporate strategy in which a firm is active in several different product markets.

geographic diversification strategy Corporate strategy in which a firm is active in several different countries.

product–market diversification strategy Corporate strategy in which a firm is active in several different product markets *and* several different countries.

LO 8-7

Describe and evaluate different types of corporate diversification.

>95%

SINGLE BUSINESS. A *single-business firm* is characterized by a low level of diversification, if any, because it derives more than 95 percent of its revenues from one business. The remainder of less than 5 percent of revenue is not (yet) significant to the success of the firm.

Founded in 1774, the German company Birkenstock only makes one product: its name-sake contoured cork shoes. Although of a more recent vintage, Facebook is also a single business at this point because it receives almost all of its revenues from online advertising.

70%-95%

R

DOMINANT BUSINESS. A *dominant-business firm* derives between 70 and 95 percent of its revenues from a single business, but it pursues at least one other business activity that accounts for the remainder of revenue. The dominant business shares competencies in products, services, technology, or distribution. In the schematic figure shown here and those to follow, the remaining revenue (*R*) is generally obtained in other strategic business units (SBU) within the firm. This remaining revenue is by definition less than that of the primary business. (Note: The areas of the boxes in this and following graphics are not scaled to specific percentages.)

Harley-Davidson, the Milwaukee-based manufacturer of the iconic Harley motorcycles, is a dominant-business firm. Of its \$5 billion in annual revenues, some 80 percent comes from selling its iconic motorcycles.⁵⁹ The remaining 20 percent of revenues come from other business activities such as motorcycle parts and accessories as well as general merchandise, including licensing the Harley logo. The brand has a loyal following overseas as well as in the United States.

related diversification strategy Corporate strategy in which a firm derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business that are linked to the primary business activity.

RELATED DIVERSIFICATION. A firm follows a **related diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business linked to the primary business activity. The rationale behind related diversification is to benefit from economies of scale and scope: These multi-business firms can pool and share resources as well as leverage competencies across different business lines. The two variations of this type, which we explain next, relate to how much the other lines of business benefit from the core competencies of the primary business activity.



Related-Constrained Diversification. A firm follows a **related-constrained diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business related to the primary business activity. Executives engage in a new business opportunity only when they can leverage their existing competencies and resources. Specifically, the choices of alternative business activities are limited—constrained—by the fact that they need to be related through common resources, capabilities, and competencies.

related-constrained diversification strategy A kind of related diversification strategy in which executives pursue only businesses where they can apply the resources and core competencies already available in the primary business.

ExxonMobil's strategic move into natural gas is an example of related diversification. In 2009, ExxonMobil bought XTO Energy, a natural gas company, for \$31 billion.⁶⁰ XTO Energy is known for its core competency to extract natural gas from unconventional places such as shale rock—the type of deposits currently being exploited in the United States. ExxonMobil hopes to leverage its core competency in the exploration and commercialization of oil into natural gas extraction. The company is producing nearly equal amounts of crude oil and natural gas, making it the world's largest producer of natural gas. The company believes that roughly 50 percent of the world's energy for the next 50 years will continue to come from fossil fuels, and that its diversification into natural gas, the cleanest of the fossil fuels in terms of greenhouse gas emissions, will pay off. ExxonMobil's strategic

scenario may be right on the mark. Because of major technological advances in hydraulic fracking to extract oil and natural gas from shale rock by companies such as XTO Energy, the United States has emerged as the world's richest country in natural gas resources and the third-largest producer of crude oil, just behind Saudi Arabia and Russia.⁶¹

Related-Linked Diversification. If executives consider new business activities that share only a limited number of linkages, the firm is using a **related-linked diversification strategy**.



related-linked diversification strategy A kind of related diversification strategy in which executives pursue various businesses opportunities that share only a limited number of linkages.

Amazon.com, featured in the ChapterCase, began business by selling only one product: books. Over time, it expanded into CDs and later gradually leveraged its online retailing capabilities into a wide array of product offerings. As the world's largest online retailer, and given the need to build huge data centers to service its peak holiday demand, Amazon decided to leverage spare capacity into cloud computing, again benefiting from economies of scope and scale. Amazon also offers a variety of consumer electronics such as tablets, e-readers, and digital virtual assistants in speakers, as well as proprietary content that can be streamed via the internet and is free for its Prime service. Amazon follows a related-linked diversification strategy.

UNRELATED DIVERSIFICATION: THE CONGLOMERATE. A firm follows an **unrelated diversification strategy** when less than 70 percent of its revenues comes from a single business and there are few, if any, linkages among its businesses. A company that combines two or more strategic business units under one overarching corporation and follows an unrelated diversification strategy is called a **conglomerate**.



unrelated diversification strategy Corporate strategy in which a firm derives less than 70 percent of its revenues from a single business and there are few, if any, linkages among its businesses.

Some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies.⁶² Such an arrangement helps firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies, such as a lack of capital markets and well-defined legal systems and property rights. Companies such as Samsung and LG (representing a uniquely South Korean form of organization, the *chaebol*), Warren Buffet's Berkshire Hathaway, and the Japanese Yamaha group are all considered conglomerates due to their unrelated diversification strategy. Strategy Highlight 8.2 features the Tata group of India, a conglomerate that follows an unrelated diversification strategy.

conglomerate A company that combines two or more strategic business units under one overarching corporation; follows an unrelated diversification strategy.

Strategy Highlight 8.2

The Tata Group: Integration at the Corporate Level

Founded in 1868 as a trading company by then 29-year-old entrepreneur Jamsetji Nusserwanji Tata, the Tata group today has roughly 660,000 employees and \$105 billion in annual revenues. A widely diversified multinational conglomerate, headquartered in Mumbai, India, its activities include tea, hospitality, steel, IT, communications, power, and automobiles. Some of its strategic business units are giants in their own right. Tata includes Asia's largest software and steel

companies (TCS and Tata Steel) and the renowned Taj Hotels Resorts and Palaces.

This diversified approach can be seen in microcosm within two divisions of one of its holdings in the automotive industry. Tata Motors started producing cars in the 1950s. In 2008 it bought luxury brands Jaguar and Land Rover from Ford for \$2.3 billion. In a seemingly disjointed effort, in 2009 the company unveiled the Tata Nano, the world's lowest-priced car. Each division follows a separate business strategy (low-cost versus differentiation).

(continued)



Tata Nano GenX starts at \$3,100.
©PUNIT PARANJPE/AFP/Getty Images

Tata Motors designed the Nano to wean India's emerging middle class from mopeds and bikes, expanding the market. Ratan Tata, then chairman of the Tata group, famously conceived of the Nano while seeing a family of four cramped on a moped in heavy rains.

LOW-COST LEADER Tata Motors hoped the Nano, engineered for a price point about 50 percent cheaper than the previously available cheapest car, would reach tens of millions of customers in the Indian and Chinese markets. But initial sales were flat. Families able to trade up from two wheels apparently found more value in a used full-featured car than a stripped-down version of a new car. The tiny Nano used much less steel than traditional cars; lacked such basics as a radio, glove compartment, and operable rear hatch; would not accommodate passengers much over



When Ratan Tata saw a family cramped on a motorcycle in heavy rains, he conceived of the Tata Nano, a super low-cost and affordable car. As the lowest-cost car on the market, the Tata Nano does not compete with other cars (the next lowest is twice the price of a Nano), but with motorcycles, thus with current nonconsumption.

©NARINDER NANU/AFP/Getty Images



The Range Rover 5.0L V8 Supercharged SV Autobiography starts at \$200,000.
©Bloomberg/Getty Images

6 feet tall; and could barely reach speeds topping 60 mph. As a plus, however, the Nano gets 67 mpg, beating the Toyota Prius for fuel consumption.

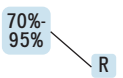
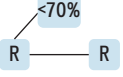
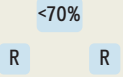
Tata Motors tried again with the Nano GenX in 2015, which brought more customizability and such features as USB ports, an audio system, Bluetooth compatibility, and an automatic transmission with a special "creeping" mode—designed to allow the car to creep forward with the engine at idle if the brake is released—a valuable feature in China and India with their massive traffic jams.

HIGH-END ICONS Contrast the Nano car division strategy of focused cost-leadership with the luxury division's strategy of focused differentiation. Launched in 2017, the Range Rover Autobiography starts at \$200,000. Tata is attempting to carve out different strategic positions in its different segments of the automotive industry. To accomplish this, the company integrates distinctly different business strategies at the corporate level.

FUTURE AT THE LOW END Sales of the Nano models had their ups and downs but generally declined in 2016 and 2017. Consumers were more tempted by competing low-cost options priced roughly at the Nano GenX price point. One competitor was the Renault Kwid. But the other Nano competitor came from Tata Motors itself. Its new Tiago model, launched in 2016 and priced similarly to the Nano GenX, is faring much better. With the Tiago, Tata may yet realize some of its ambition around the Nano.

Taken together, we can see that Tata's corporate strategy pursues distinctly different strategic positions by different strategic business units, each with its own profit and loss responsibility, and with integration at the corporate and not the operational level.⁶³

EXHIBIT 8.8 / Four Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology or distribution)	Examples	Graphic
>95%	Single business	Single business leverages its competencies.	Birkenstock Coca-Cola Facebook	
70%–95%	Dominant business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	
Related Diversification				
<70%	Related-constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	
	Related-linked	Some businesses share competencies.	Amazon Disney GE	
	Unrelated diversification (conglomerate)	Businesses share few, if any, competencies.	Samsung Berkshire Hathaway Yamaha	

NOTE: R = Remainder revenue, generally in other strategic business units (SBU) within the firm.

SOURCE: Adapted from R.P. Rumelt (1974), *Strategy, Structure, and Economic Performance* (Boston, MA: Harvard Business School Press).

Exhibit 8.8 summarizes the four main types of diversification—single business, dominant business, related diversification (including its subcategories related-constrained and related-linked diversification), and unrelated diversification.

LEVERAGING CORE COMPETENCIES FOR CORPORATE DIVERSIFICATION

In Chapter 4, when looking inside the firm, we introduced the idea that competitive advantage can be based on core competencies. Core competencies are unique strengths embedded deep within a firm. They allow companies to increase the perceived value of their product and service offerings and/or lower the cost to produce them.⁶⁴ Examples of core competencies are

- Walmart's ability to effectively orchestrate a globally distributed supply chain at low cost.
- Infosys' ability to provide high-quality information technology services at a low cost by leveraging its global delivery model. This implies taking work to the location where it makes the best economic sense, based on the available talent and the least amount of acceptable risk and lowest cost.

To survive and prosper, companies need to grow. This mantra holds especially true for publicly owned companies, because they create shareholder value through profitable

LO 8-8

Apply the core competence–market matrix to derive different diversification strategies.

core competence–market matrix A framework to guide corporate diversification strategy by analyzing possible combinations of existing/new core competencies and existing/new markets.

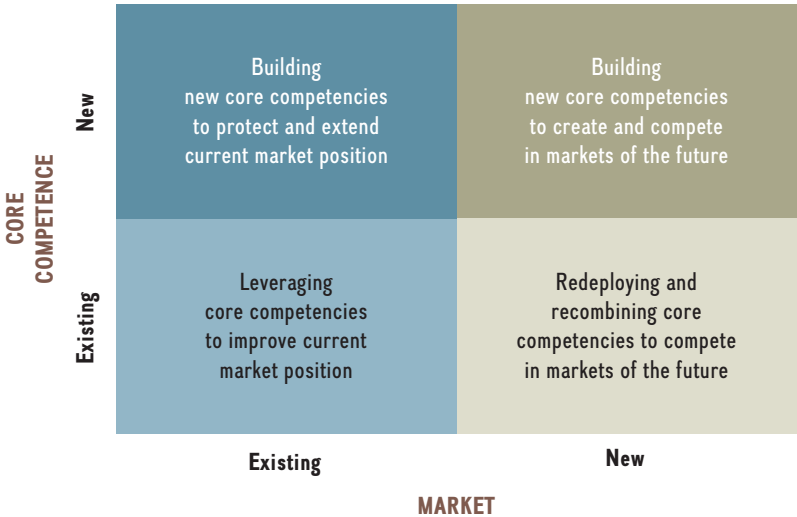
growth. Managers respond to this relentless growth imperative by leveraging their existing core competencies to find future growth opportunities. Gary Hamel and C.K. Prahalad advanced the **core competence–market matrix**, depicted in Exhibit 8.9, as a way to guide managerial decisions in regard to diversification strategies. The first task for managers is to identify their existing core competencies and understand the firm’s current market situation. When applying an existing or new dimension to core competencies and markets, four quadrants emerge, each with distinct strategic implications.

The lower-left quadrant combines existing core competencies with existing markets. Here, managers must come up with ideas of how to leverage existing core competencies to improve the firm’s current market position. Bank of America is one of the largest banks in the United States and has at least one customer in 50 percent of U.S. households.⁶⁵ Developed from the Bank of Italy and started in San Francisco, California, in 1904, it became the Bank of America and Italy in 1922. Over the next 60 years it grew in California and then nationally into a major banking powerhouse. And then in 1997, in what was the largest bank acquisition of its time, NationsBank bought Bank of America.

You could say that acquisitions were a NationsBank specialty. While still the North Carolina National Bank (NCNB), one of its unique core competencies was identifying, appraising, and integrating acquisition targets. In particular, it bought smaller banks to supplement its organic growth throughout the 1970s and ’80s, and from 1989 to 1992, NCNB purchased over 200 regional community and thrift banks to further improve its market position. It then turned its core competency to national banks, with the goal of becoming the first nationwide bank. Known as NationsBank in the 1990s, it purchased Barnett Bank, BankSouth, FleetBank, LaSalle, CountryWide Mortgages, and its eventual namesake, Bank of America. This example illustrates how NationsBank, rebranded as Bank of America since 1998, honed and deployed its core competency of selecting, acquiring, and integrating other commercial banks to grow dramatically in size and geographic scope and emerge as one of the leading banks in the United States. As a key vehicle of corporate strategy, we study acquisitions in more detail in Chapter 9.

The lower-right quadrant of Exhibit 8.9 combines existing core competencies with new market opportunities. Here, leaders must strategize about how to redeploy and recombine

EXHIBIT 8.9 / The Core Competence–Market Matrix



SOURCE: Adapted from G. Hamel and C.K. Prahalad (1994), *Competing for the Future* (Boston, MA: Harvard Business School Press).

existing core competencies to compete in future markets. During the global financial crisis in 2008, Bank of America bought the investment bank Merrill Lynch for \$50 billion.⁶⁶ Although many problems ensued for Bank of America following the Merrill Lynch acquisition, it is now the bank’s investment and wealth management division. Bank of America’s corporate managers applied an existing competency (acquiring and integrating) into a new market (investment and wealth management). The combined entity is now leveraging economies of scope through cross-selling when, for example, consumer banking makes customer referrals for investment bankers to follow up.⁶⁷

The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives to build new core competencies to protect and extend the company's current market position. For example, in the early 1990s, Gatorade dominated the market for sports drinks, a segment in which it had been the original innovator. Some 25 years earlier, medical researchers at the University of Florida had created the drink to enhance the performance of the Gators, the university's football team, thus the name Gatorade. Stokely-Van Camp commercialized and marketed the drink, and eventually sold it to Quaker Oats. PepsiCo brought Gatorade into its lineup of soft drinks when it acquired Quaker Oats in 2001.

By comparison, Coca-Cola had existing core competencies in marketing, bottling, and distributing soft drinks, but had never attempted to compete in the sports-drink market. Over a 10-year R&D effort, Coca-Cola developed competencies in the development and marketing of its own sports drink, Powerade, which launched in 1990. In 2015, Powerade held about 20 percent of the sports-drink market, making it a viable competitor to Gatorade, which still holds close to 80 percent of the market.⁶⁸

Finally, the upper-right quadrant combines new core competencies with new market opportunities. Hamel and Prahalad call this combination “mega-opportunities”—those that hold significant future-growth opportunities. At the same time, it is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

Salesforce.com, for example, is a company that employs this diversification strategy well.⁶⁹ In recent years, Salesforce experienced tremendous growth, the bulk of it coming from the firm's existing core competency in delivering customer relationship management (CRM) software to its clients. Salesforce's product distinguished itself from the competition by providing software as a service via cloud computing: Clients did not need to install software or manage any servers, but could easily access the CRM through a web browser (a business model called *software as a service*, or *SaaS*). In 2007, Salesforce recognized an emerging market for *platform as a service (PaaS)* offerings, which would enable clients to build their own software solutions that are accessed the same way as the Salesforce CRM. Seizing the opportunity, Salesforce developed a new competency in delivering software development and deployment tools that allowed its customers to either extend their existing CRM offering or build completely new types of software. Today, Salesforce's Force.com offering is one of the leading providers of PaaS tools and services.

Taken together, the core competence–market matrix provides guidance to executives on how to diversify in order to achieve continued growth. Once managers have a clear understanding of their firm's core competencies (see Chapter 4), they have four options to formulate corporate strategy:

Four Options to Formulate Corporate Strategy via Core Competencies

1. Leverage existing core competencies to improve current market position.
2. Build new core competencies to protect and extend current market position.
3. Redeploy and recombine existing core competencies to compete in markets of the future.
4. Build new core competencies to create and compete in markets of the future.

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

Corporate managers pursue diversification to gain and sustain competitive advantage. But does corporate diversification indeed lead to superior performance? To answer this question, we need to evaluate the performance of diversified companies. The critical question

LO 8-9

Explain when a diversification strategy does create a competitive advantage and when it does not.

to ask when doing so is whether the individual businesses are worth more under the company's management than if each were managed individually.

The diversification-performance relationship is a function of the underlying type of diversification. A cumulative body of research indicates an inverted U-shaped relationship between the type of diversification and overall firm performance, as depicted in Exhibit 8.10.⁷⁰ High and low levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance. This implies that companies that focus on a single business, as well as companies that pursue unrelated diversification, often fail to achieve additional value creation. Firms that compete in single markets could potentially benefit from economies of scope by leveraging their core competencies into adjacent markets.

Firms that pursue unrelated diversification are often unable to create additional value. They experience a **diversification discount**: The stock price of such highly diversified firms is valued at less than the sum of their individual business units.⁷¹ For the last decade or so, GE experienced a diversification discount, as its capital unit contributed 50 percent of profits on one-third of the conglomerate's revenues. The presence of the diversification discount in GE's depressed stock price was a major reason GE's then CEO, Jeffrey Immelt, decided in 2015 to spin out GE Capital. On the day of the announcement, GE's stock price jumped 11 percent, adding some \$28 billion to GE's market capitalization. This provides some idea of the diversification discount that firms pursuing unrelated diversification may experience.⁷² Through this restructuring of the corporate portfolio, GE is now better positioned to focus more fully on its core competencies in industrial engineering and management processes.

The presence of the diversification discount, however, depends on the institutional context. Although it holds in developed economies with developed capital markets, some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies as mentioned when discussing Tata in Strategy Highlight 8.2.⁷³ Here, unrelated diversification may help firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies such as a lack of a functioning capital market.

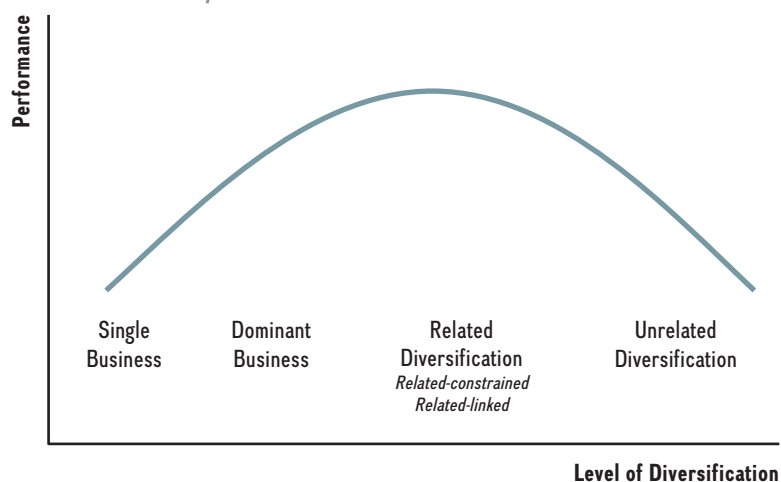
In contrast, companies that pursue related diversification are more likely to improve their performance. They create a **diversification premium**: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.⁷⁴

Why is this so? At the most basic level, a corporate diversification strategy enhances firm performance when its value creation is greater than the costs it incurs. Exhibit 8.11 lists the sources of value creation and costs for different corporate strategies, for vertical integration as well as related and unrelated diversification. For diversification to enhance firm performance, it must do at least one of the following:

diversification discount Situation in which the stock price of highly diversified firms is valued at less than the sum of their individual business units.

diversification premium Situation in which the stock price of related-diversification firms is valued at greater than the sum of their individual business units.

EXHIBIT 8.10 / The Diversification-Performance Relationship



SOURCE: Adapted from L.E. Palich, L.B. Cardinal, and C.C. Miller (2001), "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research," *Strategic Management Journal* 21: 155–174.

Corporate Strategy	Sources of Value Creation (V)	Sources of Costs (C)
Vertical Integration	• Can lower costs • Can improve quality • Can facilitate scheduling and planning • Facilitating investments in specialized assets • Securing critical supplies and distribution channels	• Can increase costs • Can reduce quality • Can reduce flexibility • Increasing potential for legal repercussions
Related Diversification	• Economies of scope • Economies of scale • Financial economies ■ Restructuring ■ Internal capital markets	• Coordination costs • Influence costs
Unrelated Diversification	• Financial economies ■ Restructuring ■ Internal capital markets	• Influence costs

EXHIBIT 8.11

Vertical Integration and Diversification: Sources of Value Creation and Costs

- Provide *economies of scale*, which reduces costs.
- Exploit *economies of scope*, which increases value.
- Reduce costs *and* increase value.

We discussed these drivers of competitive advantage—economies of scale, economies of scope, and increase in value and reduction of costs—in depth in Chapter 6 in relation to business strategy. Other potential benefits to firm performance when following a diversification strategy include *financial economies*, resulting from *restructuring* and using *internal capital markets*.

RESTRUCTURING. *Restructuring* describes the process of reorganizing and divesting business units and activities to refocus a company to leverage its core competencies more fully. The Belgium-based Anheuser-Busch InBev sold Busch Entertainment, its theme park unit that owns SeaWorld and Busch Gardens, to a group of private investors for roughly \$3 billion. This strategic move allows InBev to focus more fully on its core business of brewing and distributing beer across the world.⁷⁵

Corporate executives can restructure the portfolio of their firm's businesses, much like an investor can change a portfolio of stocks. One helpful tool to guide corporate portfolio planning is the **Boston Consulting Group (BCG) growth-share matrix**, shown in Exhibit 8.12.⁷⁶ This matrix locates the firm's individual SBUs in two dimensions:

- Relative market share (horizontal axis).
- Speed of market growth (vertical axis).

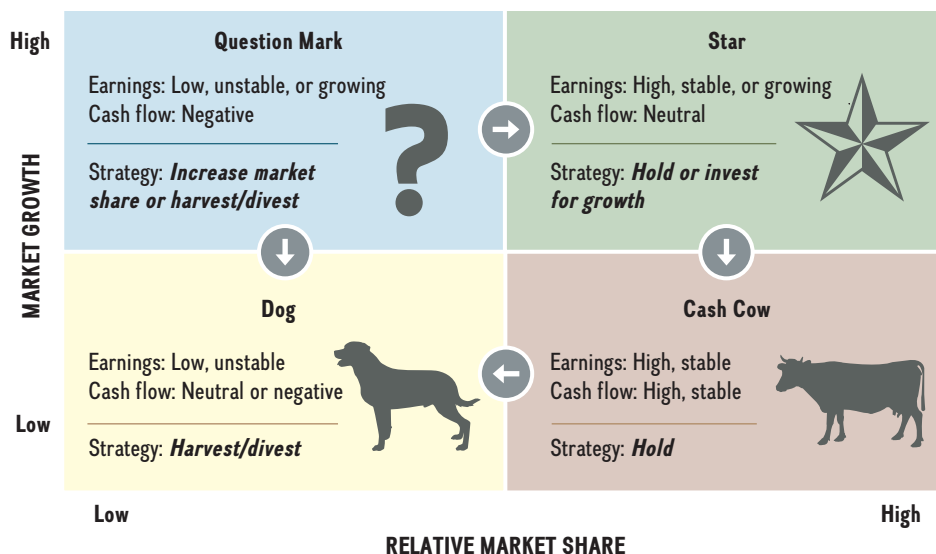
The firm plots its SBUs into one of four categories in the matrix: *dog*, *cash cow*, *star*, and *question mark*. Each category warrants a different investment strategy. All four categories shape the firm's corporate strategy.

SBUs identified as *dogs* are relatively easy to identify: They are the underperforming businesses. Dogs hold a small market share in a low-growth market; they have low and

Boston Consulting Group (BCG) growth-share matrix A corporate planning tool in which the corporation is viewed as a portfolio of business units, which are represented graphically along relative market share (horizontal axis) and speed of market growth (vertical axis). SBUs are plotted into four categories (dog, cash cow, star, and question mark), each of which warrants a different investment strategy.

EXHIBIT 8.12 /

Restructuring
the Corporate
Portfolio: The Boston
Consulting Group
Growth–Share Matrix



unstable earnings, combined with neutral or negative cash flows. The strategic recommendations are either to *divest* the business or to *harvest* it. This implies stopping investment in the business and squeezing out as much cash flow as possible before shutting it or selling it.

Cash cows, in contrast, are SBUs that compete in a low-growth market but hold considerable market share. Their earnings and cash flows are high and stable. The strategic recommendation is to invest enough into cash cows to hold their current position and to avoid having them turn into dogs (as indicated by the arrow in Exhibit 8.12). As a general rule, strategic leaders would want to manage their SBU portfolio in a clockwise manner (as indicated by three of the four arrows).

A corporation's *star* SBUs hold a high market share in a fast-growing market. Their earnings are high and either stable or growing. The recommendation for the corporate strategist is to invest sufficient resources to hold the star's position or even increase investments for future growth. As indicated by the arrow, stars may turn into cash cows as the market in which the SBU is situated slows after reaching the maturity stage of the industry life cycle.

Finally, some SBUs are *question marks*: It is not clear whether they will turn into dogs or stars (as indicated by the arrows in Exhibit 8.12). Their earnings are low and unstable, but they might be growing. The cash flow, however, is negative. Ideally, corporate executives want to invest in question marks to increase their relative market share so they turn into stars. If market conditions change, however, or the overall market growth slows, then a question-mark SBU is likely to turn into a dog (as indicated by the arrow). In this case, executives would want to harvest the cash flow or divest the SBU.

INTERNAL CAPITAL MARKETS. *Internal capital markets* can be a source of value creation in a diversification strategy if the conglomerate's headquarters does a more efficient job of allocating capital through its budgeting process than what could be achieved in external capital markets. Based on private information, corporate managers are in a position to discover which of their strategic business units will provide the highest return on invested capital. In addition, internal capital markets may allow the company to access capital at a lower cost.

Until recently, for example, GE Capital brought in close to \$70 billion in annual revenues and generated more than half of GE's profits.⁷⁷ In combination with GE's triple-A debt rating, having access to such a large finance arm allowed GE to benefit from a lower cost of capital, which in turn was a source of value creation in itself. In 2009, at the height of the global financial crises, GE lost its AAA debt rating. The lower debt rating and the smaller finance unit were likely to result in a higher cost of capital, and thus a potential loss in value creation through internal capital markets. As mentioned above, GE sold its GE Capital business unit in 2015 in a restructuring of its corporate portfolio.

A strategy of related-constrained or related-linked diversification is more likely to enhance corporate performance than either a single or dominant level of diversification or an unrelated level of diversification. The reason is that the sources of value creation include not only restructuring, but also the potential benefits of economies of scope and scale. To create additional value, however, the benefits from these sources of incremental value creation must outweigh their costs. A related-diversification strategy entails two types of costs: coordination and influence costs. *Coordination costs* are a function of the number, size, and types of businesses that are linked. *Influence costs* occur due to political maneuvering by managers to influence capital and resource allocation and the resulting inefficiencies stemming from suboptimal allocation of scarce resources.⁷⁸

8.5 Implications for Strategic Leaders

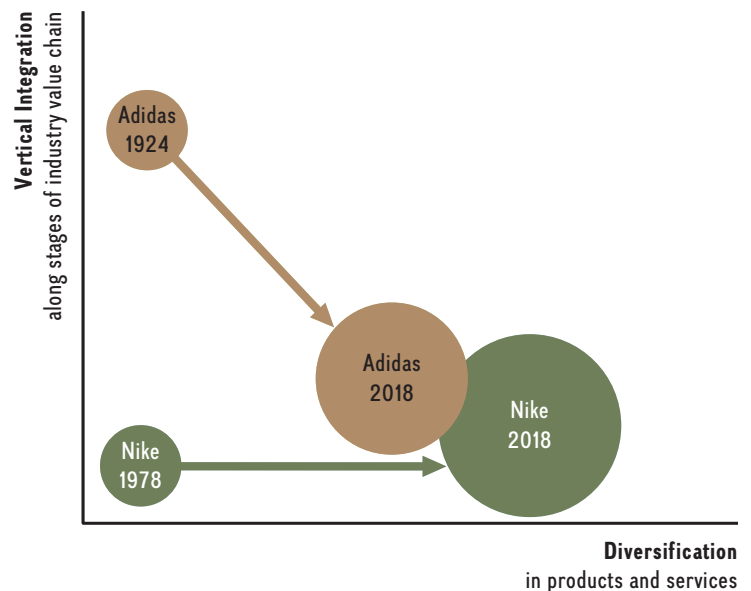
An effective corporate strategy increases a firm's chances to gain and sustain a competitive advantage. By formulating corporate strategy, strategic leaders make important choices along three dimensions that determine the boundaries of the firm:

- **The degree of vertical integration**—in what stages of the industry value chain to participate.
- **The type of diversification**—what range of products and services to offer.
- **The geographic scope**—where to compete.

Since a firm's external environment never remains constant over time, *corporate strategy needs to be dynamic over time*. As firms grow, they tend to diversify and globalize to capture additional growth opportunities. Exhibit 8.13 shows the dynamic nature of corporate strategy through decisions made by two top competitors in the sports footwear and apparel industry: Nike and Adidas.

Adidas was founded in 1924 in Germany. It began its life in the laundry room of a small apartment. Two brothers focused on one product: athletic shoes. Initially, Adidas was a fairly integrated manufacturer of athletic shoes. The big breakthrough for the company came in 1954 when the underdog West Germany won the soccer World Cup in Adidas cleats. As the world markets globalized and became more competitive in the

EXHIBIT 8.13 / Dynamic Corporate Strategy: Nike vs. Adidas



decades after World War II, Adidas not only vertically disintegrated to focus mainly on the design of athletic shoes but also diversified into sports apparel. Adidas' annual revenues are \$21 billion. It is a diversified company active across the globe in sports shoes (40 percent of revenues), sports apparel (50 percent of revenues), and sports equipment (10 percent of revenues). The change in Adidas' corporate strategy from a small, highly integrated single business to a disintegrated and diversified global company is shown in Exhibit 8.13.

Nike is the world's leader in sports shoes and apparel with annual sales of \$34 billion. Founded in 1978, and thus much younger than Adidas, Nike was vertically disintegrated from the very beginning. After moving beyond importing Japanese ASICS shoes to the United States, Nike focused almost exclusively on R&D, design, and marketing of running shoes. Although Nike diversified into different lines of business, it stayed true to its vertical disintegration by focusing on only a few activities (see Exhibit 8.13). Nike is a global company and its revenues come from sports shoes (50 percent) and apparel (25 percent), as well as sports equipment and other businesses, such as affiliate brands Cole Haan, Converse, Hurley, and Umbro.

The changes in the strategic positions shown in Exhibit 8.13 highlight the dynamic nature of corporate strategy. Also, keep in mind that the relationship between diversification strategy and competitive advantage depends on the *type of diversification*. There exists an inverted U-shaped relationship between the level of diversification and performance improvements. On average, related diversification (either related-constrained or related-linked such as in the Nike and Adidas example) is most likely to lead to superior performance because it taps into multiple sources of value creation (economies of scale and scope; financial economies). To achieve a net positive effect on firm performance, however, related diversification must overcome additional sources of costs such as coordination and influence costs.

In the next chapter, we discuss strategic alliances in more depth as well as mergers and acquisitions, both are critical tools in executing corporate strategy. In Chapter 10, we take a closer look at geographic diversification by studying how firms compete for competitive advantage around the world.

CHAPTERCASE 8 / Consider This. . .

ALTHOUGH AMAZON is one of the largest technology companies globally in terms of its stock market valuation, several problems loom at the horizon. Amazon's annual revenues are some \$140 billion, but consistent profitability continues to elude the company. Moreover, as technology has evolved, traditional boundaries between hardware and software, products and services, and online and brick-and-mortar stores have become increasingly blurred. As a result, Amazon finds itself engaged in a fierce competitive battle for control of the emerging digital ecosystem, pitted against technology giants such as Apple, Alphabet, and Facebook. In retailing Amazon competes with Walmart and the Chinese ecommerce company Alibaba. In data services and cloud computing, it

competes with Microsoft, IBM, and others. Indeed, the list of Amazon's competitors keeps increasing rapidly, as this passage from its 2016 annual report makes clear:⁷⁹

"Our businesses encompass a large variety of product types, service offerings, and delivery channels. . . . [W]e face a broad array of competitors from many different industry sectors around the world [including]: (1) online, offline, and multichannel retailers,



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publishers, vendors, distributors, manufacturers, and producers of the products we offer. . . ; (2) publishers, producers, and distributors of physical, digital, and interactive media of all types and all distribution channels; (3) web search engines, comparison shopping websites, social networks, [and] web portals. . . ; (4) companies that provide ecommerce services. . . ; (5) companies that provide fulfillment and logistics services. . . online or offline; (6) companies that provide information technology services or products. . . ; and (7) companies that design, manufacture, market, or sell consumer electronics, telecommunication, and electronic devices.”

Even Amazon’s 2017 acquisition (spending close to \$14 billion, more than any previous acquisition) on high-end grocer Whole Foods raises as many potential problems as opportunities. With the purchase, Amazon is likely looking to maximize a hybrid of online sales with physical delivery points, and use its huge data stockpile to reverse-engineer the retail experience in the grocery space. There are also suggestions that Amazon’s ability to squeeze labor costs out of an operation and to operate for extended periods at a loss provides an opportunity to push competitors into an area where they won’t be able to compete effectively. However, we don’t know how well Amazon’s tactics will succeed. And the grocery industry has shown itself to be fiercely competitive in the past. In terms of opportunities, the purchase of Whole Foods Market allows Amazon to compete more effectively

with Walmart, which is the largest grocer in the United States, and has been quite successful with its hybrid approach to retailing, combining online purchases with same day in-store pick-ups.⁸⁰

Questions

1. Describe Amazon’s diversification strategy using Exhibit 8.8. What type of diversification strategy is Amazon pursuing? Explain.
2. What is Amazon’s core business? Is AWS related to Amazon’s core business? Why or why not? Some investors are pressuring Jeff Bezos to spin out AWS as a standalone company. Do you agree with this corporate strategy recommendation? Why or why not? Hint: Do you believe AWS would be more valuable within Amazon or as a standalone company?
3. Amazon.com is now 25 years old and makes \$140 billion in annual revenues. As an investor, would it concern you that Amazon.com has yet to deliver any consistent profits? Why or why not? How much longer do you think investors will be patient with Jeff Bezos as he continues to pursue billion-dollar diversification initiatives?
4. Amazon.com continues to spend billions on seemingly unrelated diversification efforts. Do you believe these efforts contribute to Amazon gaining and sustaining a competitive advantage? Why or why not?

TAKE-AWAY CONCEPTS

This chapter defined corporate strategy and then looked at two fundamental corporate strategy topics—vertical integration and diversification—as summarized by the following learning objectives and related take-away concepts.

LO 8-1 / Define corporate strategy and describe the three dimensions along which it is assessed.

- Corporate strategy addresses “where to compete.” Business strategy addresses “how to compete.”
- Corporate strategy concerns the boundaries of the firm along three dimensions: (1) industry value chain, (2) products and services, and (3) geography (regional, national, or global markets).

- To gain and sustain competitive advantage, any corporate strategy must support and strengthen a firm’s strategic position, regardless of whether it is a differentiation, cost-leadership, or blue ocean strategy.

LO 8-2 / Explain why firms need to grow, and evaluate different growth motives.

- Firm growth is motivated by the following: increasing profits, lowering costs, increasing market power, reducing risk, and managerial motives.
- Not all growth motives are equally valuable.
- Increasing profits and lowering expenses are clearly related to enhancing a firm’s competitive advantage.

- Increasing market power can also contribute to a greater competitive advantage, but can also result in legal repercussions such as antitrust lawsuits.
- Growing to reduce risk has fallen out of favor with investors, who argue that they are in a better position to diversify their stock portfolio in comparison to a corporation with a number of unrelated strategic business units.
- Managerial motives such as increasing company perks and job security are not legitimate reasons a firm needs to grow.

LO 8-3 / Describe and evaluate different options firms have to organize economic activity.

- Transaction cost economics help managers decide what activities to do in-house (“make”) versus what services and products to obtain from the external market (“buy”).
- When the costs to pursue an activity in-house are less than the costs of transacting in the market ($C_{\text{in-house}} < C_{\text{market}}$), then the firm should vertically integrate.
- Principal–agent problems and information asymmetries can lead to market failures, and thus situations where internalizing the activity is preferred.
- A principal–agent problem arises when an agent, performing activities on behalf of a principal, pursues his or her own interests.
- Information asymmetries arise when one party is more informed than another because of the possession of private information.
- Moving from less integrated to more fully integrated forms of transacting, alternatives include short-term contracts, strategic alliances (including long-term contracts, equity alliances, and joint ventures), and parent–subsidiary relationships.

LO 8-4 / Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

- Vertical integration denotes a firm’s addition of value—what percentage of a firm’s sales is generated by the firm within its boundaries.
- Industry value chains (vertical value chains) depict the transformation of raw materials into finished goods and services. Each stage typically represents a distinct industry in which a number of different firms compete.

- Backward vertical integration involves moving ownership of activities upstream nearer to the originating (inputs) point of the industry value chain.
- Forward vertical integration involves moving ownership of activities closer to the end (customer) point of the value chain.

LO 8-5 / Identify and evaluate benefits and risks of vertical integration.

- Benefits of vertical integration include securing critical supplies and distribution channels, lowering costs, improving quality, facilitating scheduling and planning, and facilitating investments in specialized assets.
- Risks of vertical integration include increasing costs, reducing quality, reducing flexibility, and increasing the potential for legal repercussions.

LO 8-6 / Describe and examine alternatives to vertical integration.

- Taper integration is a strategy in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.
- Strategic outsourcing involves moving one or more value chain activities outside the firm’s boundaries to other firms in the industry value chain. Offshoring is the outsourcing of activities outside the home country.

LO 8-7 / Describe and evaluate different types of corporate diversification.

- A single-business firm derives 95 percent or more of its revenues from one business.
- A dominant-business firm derives between 70 and 95 percent of its revenues from a single business, but pursues at least one other business activity.
- A firm follows a related diversification strategy when it derives less than 70 percent of its revenues from a single business activity, but obtains revenues from other lines of business that are linked to the primary business activity. Choices within a related diversification strategy can be related-constrained or related-linked.
- A firm follows an unrelated diversification strategy when less than 70 percent of its revenues come from a single business, and there are few, if any, linkages among its businesses.

LO 8-8 / Apply the core competence–market matrix to derive different diversification strategies.

- When applying an existing/new dimension to core competencies and markets, four quadrants emerge, as depicted in Exhibit 8.9.
- The lower-left quadrant combines existing core competencies with existing markets. Here, managers need to come up with ideas of how to leverage existing core competencies to improve their current market position.
- The lower-right quadrant combines existing core competencies with new market opportunities. Here, managers need to think about how to redeploy and recombine existing core competencies to compete in future markets.
- The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives of how to build new core competencies to protect and extend the firm's current market position.
- The upper-right quadrant combines new core competencies with new market opportunities. This is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

LO 8-9 / Explain when a diversification strategy does create a competitive advantage and when it does not.

- The diversification-performance relationship is a function of the underlying type of diversification.
- The relationship between the type of diversification and overall firm performance takes on the shape of an inverted U (see Exhibit 8.10).
- Unrelated diversification often results in a diversification discount: The stock price of such highly diversified firms is valued at less than the sum of their individual business units.
- Related diversification often results in a diversification premium: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.
- In the BCG matrix, the corporation is viewed as a portfolio of businesses, much like a portfolio of stocks in finance (see Exhibit 8.12). The individual SBUs are evaluated according to relative market share and the speed of market growth, and are plotted using one of four categories: dog, cash cow, star, and question mark. Each category warrants a different investment strategy.
- Both low levels and high levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance.

KEY TERMS

Backward vertical
integration (p. 280)

Boston Consulting Group (BCG)
growth–share matrix (p. 295)

Conglomerate (p. 289)

Core competence–market
matrix (p. 292)

Corporate strategy (p. 268)

Credible commitment (p. 277)

Diversification (p. 287)

Diversification discount (p. 294)

Diversification premium (p. 294)

External transaction costs (p. 271)

Forward vertical integration
(p. 281)

Franchising (p. 275)

Geographic diversification
strategy (p. 287)

Industry value chain (p. 278)

Information asymmetry (p. 274)

Internal transaction costs (p. 271)

Joint venture (p. 277)

Licensing (p. 275)

Principal–agent problem (p. 273)

Product diversification strategy
(p. 287)

Product–market diversification
strategy (p. 287)

Related-constrained diversification
strategy (p. 288)

Related diversification
strategy (p. 288)

Related-linked diversification
strategy (p. 289)

Specialized assets (p. 282)

Strategic alliances (p. 275)

Strategic outsourcing (p. 285)

Taper integration (p. 284)

Transaction cost
economics (p. 271)

Transaction costs (p. 271)

Unrelated diversification strat-
egy (p. 289)

Vertical integration (p. 278)

Vertical market failure (p. 284)

DISCUSSION QUESTIONS

1. When Walmart decided to incorporate grocery stores into some locations and created “supercenters,” was this a business-level strategy of differentiation or a corporate strategy of diversification? Why? Explain your answer.
2. How can related diversification create a competitive advantage for the firm? Keeping the advantages of related diversification in mind, think back to the example of Delta’s vertical integration decision to acquire an oil refinery—clearly an unrelated diversification move. What challenges might Delta confront in operating this refinery? Think of the strategic concepts you have learned and how they can help you evaluate Delta’s decision.
3. Franchising is widely used in the casual dining and fast food industry, yet Starbucks is quite successful with a large number of company-owned stores. In 2016 Starbucks had more than 7,800 company-owned stores in the United States. How do you explain this difference? Is Starbucks bucking the trend of other food-service stores, or is something else going on?

ETHICAL/SOCIAL ISSUES

1. The chapter notes that some firms choose to outsource their human resource management systems. If a firm has a core value of respecting its employees and rewarding top performance with training, raises, and promotions, does outsourcing HR management show a lack of commitment by the firm? HR management systems are software applications that typically manage payroll, benefits, hiring and training, and performance appraisal. What are the advantages and disadvantages of this decision? Think of ways that a firm can continue to show its commitment to treat employees with respect.
2. Nike is a large and successful firm in the design of athletic shoes. It could easily decide to forward-integrate to manufacture the shoes it designs. Therefore, the firm has a credible threat over its current manufacturers. If Nike has no intention of actually entering the manufacturing arena, is its supply chain management team being ethical with the current manufacturers if the team mentions this credible threat numerous times in annual pricing negotiations? Why or why not?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Agriculture is one of the largest and oldest industries in the world. In the United States and many other countries, farmers often struggle to turn a profit given the variabilities of weather and commodity prices. Some working farms are turning to tourism as an additional and complementary revenue source. A study from the U.S. Census of Agriculture in 2012 found over 13,000 farms generated \$674 million in revenues from tourist and recreational activities. This is a 23 percent jump over revenues in the prior agricultural census in 2007. In 2014, in response to rapid growth, the National Agritourism Professionals Association was formed to help farmers learn how to add this aspect of business to their traditional farms and ranches.

One of the most successful large companies leading this marriage of industries is a dairy farm in Indiana: Fair Oaks Farms (www.fofarms.com) is home to 37,000 cows and produces enough milk to feed over 8 million people. Fair Oaks is also participating in the education market as a popular destination for school field trips. Other attractions include the Birthing Barn, where calf births can be viewed live; the Cheese Factory; and Mooville, a themed outdoor play area. Fair Oaks grew beyond the dairy and added a Pig Adventure in 2014 and a Crop Adventure in 2016. Each year, Fair Oaks Farms hosts more than 600,000 visitors including 50,000 kids on school field trips. A video of the operation by the CEO is available at https://www.youtube.com/watch?v=Dz_gE4887so. Such ingenious

business diversification can offer many benefits to the agriculture industry.⁸¹

1. What other industrial or commercial industries could benefit from such potential tourist or recreational revenues? Discuss what new and complementary capabilities would need to be developed in order to succeed.
2. In your group, list other industry combinations you have seen be successful. Consider why you think the combination has been a success.

//// Small Group Exercise 2

The ChapterCase 8 opener mentioned Amazon's Campus initiative. It was developed to compete directly with university bookstores. This is a good corporate strategy for Amazon for many reasons—among them, it provides the company deeper access into the shopping behavior of college students, as well as of their media viewing purchases and habits. It also represents another large competitive threat to Barnes & Noble, which runs more than 700 campus bookstores. To make it beneficial for universities to partner with Amazon, Amazon pays the schools between 0.5 and 2.5 percent of all Amazon purchases made through the university website. Purdue University, one of the first universities to sign on, reportedly has made \$1 million

from Amazon in the first two years of the program. Sixteen campuses had signed up by the end of 2016 with rapid continued growth expected.

In August 2015 Barnes & Noble spun off its college bookstore unit into a separate company called Barnes & Noble Education (BNED on the NYSE). The firm stated the split allows each business to focus on its core. Barnes & Noble will focus on the consumer retail business, which has suffered from online shopping and digital books. The new firm will focus on the higher education market, putting it perhaps in a better position to seek acquisitions on its own.

1. In your small group, discuss any potential ethical issues with Amazon paying the university administration for direct access into the school's course textbook system.
2. While Amazon as a firm continues to diversify its products, services, and markets under one corporate umbrella, why do firms such as Barnes & Noble choose to split into separate firms for greater focus on each piece of the business? Do these different strategies align with the core competencies of each? It may be helpful to review Exhibit 8.9.
3. If your team was asked to consult for Barnes & Noble Education, which corporate strategies would you recommend to the company's senior leadership?

mySTRATEGY

How Diversified Are You?

Corporations diversify by investing time and resources into new areas of business. As individuals, each of us makes choices about how to spend our time and energies. Typically, we could divide our time between school, work, family, sleep, and play. During high-stress work projects, we likely devote more of our time to work; when studying for final exams or a professional board exam (such as the CPA exam), we probably spend more time and effort in the "student learning" mode. This manner of dividing our time can be thought of as "personal diversification." Just as companies can invest in related or unrelated activities, we make similar choices. While we attend college, we may choose to engage in social and leisure activities with campus colleagues, or we may focus on classwork at school and spend our "play time" with an entirely separate set of people.

Using Exhibit 8.8 as a guide, list each of your major activity areas. Think of each of these as a business. (If you are literally

"all work and no play," you are a single-business type of personal diversification.) Instead of revenues, estimate the percentage of *time you spend per week* in each activity. (Most people will be diversified, though some may be dominant perhaps in school or work.) To assess your degree of *relatedness* and *unrelatedness*, consider the subject matter and community involved with each activity. For example, if you are studying ballet and working as an accountant, those would be largely unrelated activities (unless you are an accountant for a ballet company!).

1. What conclusions do you derive based on your personal diversification strategy?
2. Do you need to make adjustments to your portfolio of activities? Explain the reasons for your answer.
3. Let's consider dynamics—has your level of diversification changed over time (say, over the last five years)? Looking toward the future, do you expect your level of diversification to change as you complete your degree? Why or why not?

ENDNOTES

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CHAPTER

9

Corporate Strategy: Strategic Alliances, Mergers and Acquisitions

Chapter Outline

- 9.1** How Firms Achieve Growth
The Build-Borrow-Buy Framework
- 9.2** Strategic Alliances
Why Do Firms Enter Strategic Alliances?
Governing Strategic Alliances
Alliance Management Capability
- 9.3** Mergers and Acquisitions
Why Do Firms Merge with Competitors?
Why Do Firms Acquire Other Firms?
M&A and Competitive Advantage
- 9.4** Implications for Strategic Leaders

Learning Objectives

- LO 9-1** Apply the build-borrow-or-buy framework to guide corporate strategy.
- LO 9-2** Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.
- LO 9-3** Describe three alliance governance mechanisms and evaluate their pros and cons.
- LO 9-4** Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.
- LO 9-5** Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.
- LO 9-6** Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.
- LO 9-7** Explain why firms engage in acquisitions.
- LO 9-8** Evaluate whether mergers and acquisitions lead to competitive advantage.

Little Lyft Gets Big Alliance Partners

WITH A VALUATION of close to \$70 billion in 2017, Uber is the most valuable privately held company ever. Serving some 600 cities in over 60 countries worldwide, Uber dominates the global car-hailing app market. The number-two competitor to Uber in the United States is Lyft, which is also a privately held startup but only worth about one-tenth of Uber (some \$7.5 billion). What should little Lyft do to compete against the giant Uber? Lyft is clearly the underdog in the fiercely competitive ride-hailing app market. Similarly to dealing with a schoolyard bully, it helps to have strong friends. Lyft found itself powerful alliance partners for a number of strategic reasons.

Strengthen Competitive Position. Strategic alliances with powerful partners enable Lyft to strengthen its competitive position against Uber. In particular, Lyft entered two important alliances. In 2016, Lyft formed an equity alliance with GM, which invested \$500 million in the startup. A year later, Lyft announced an alliance with Waymo, an autonomous car technology venture and a subsidiary of Alphabet, which is also Google's parent company.

Waymo is also a fierce rival of Uber in the development of self-driving car technology. When Lyft announced its alliance with Waymo in 2017, Alphabet and Uber were entangled in a lawsuit. In particular, Alphabet alleged that Uber stole proprietary technology when acquiring Otto, a self-driving technology company mainly for trucks, which was founded by a former Waymo executive who headed its self-driving car efforts. Thus, the alliance with Waymo allows Lyft to

strengthen its competitive position vis-à-vis Uber. Having autonomous vehicle technology succeed is critical for both Uber and Lyft because human drivers are the biggest cost factor in offering rides. Moreover, autonomous-driving technology is also expected to be safer than human driving, resulting in fewer accidents. In addition, since smart traffic guidance can be employed much more easily with self-driving cars that can run 24/7, 365 days a year, traffic congestion and delays are expected to be much fewer, if any.

Enter New Markets. The alliance with Lyft allows GM to tap into the second largest mobile transportation network globally. The goal is that GM's cars will be deployed on Lyft's network, ideally as self-driving vehicles. The equity alliance with Lyft affords GM an entry into the mobile transportation and logistics market.

Hedge Against Uncertainty. The equity investment in Lyft also allows GM to hedge against uncertainty. With network effects supporting winner-take-all dynamics, it is likely that only one or a few at best mobile transportation

companies survive in the long run. GM is betting on Lyft and wants to be in this new market because the age-old private car ownership model is likely to shift in favor of fleet ownership and management. Consumers will "rent" a car for a specific ride, rather than own the fixed asset. Noteworthy is that private cars in the United States are used

only 5 percent of the time, and sit idle for most of the day. Car owners have the fixed costs of purchasing a car, buying insurance, and maintaining the car. All this goes away with the new business model that is likely to emerge.

Learn New Capabilities. For instance, Lyft may need to learn how to manage large fleets of cars that it might eventually need to own, a capability held by GM as key supplier to many large car rental companies. In addition,



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Lyft may want to learn some of the self-driving technology from Waymo. Conversely, the Alphabet subsidiary might be motivated to learn more about how to establish and maintain a large mobile logistics network that it can leverage into

more precise target advertising for its Google partner division, or other new services it might want to offer one day.¹

You will learn more about Lyft by reading this chapter; related questions appear in “ChapterCase 9 / Consider This . . .”



THE CHAPTERCASE highlights how Lyft uses strategic alliances with GM and Waymo in an attempt to close the gap with Uber. Lyft’s strategic leaders realize that it is difficult for the much smaller ride-hailing company to catch up with Uber on its own. Lyft thus is reaching out to powerful partners. Tapping into its partners’ resources and expertise allows Lyft to become a much more potent rival to Uber than as a standalone company. This example shows how strategic alliances can help firms to grow and to possibly outperform much stronger rivals.

In Chapter 8, we discussed *why* firms grow. In this chapter we discuss *how* firms grow. In addition to internal organic growth (achieved through reinvesting profits, see discussion of Exhibit 4.3 in Chapter 4), firms have two critical strategic options to execute corporate strategy: *alliances* and *acquisitions*. We devote this chapter to the study of these fundamental pathways through which firms implement corporate strategy.

We begin this chapter by introducing the *build-borrow-or-buy framework* to guide corporate strategy in deciding whether and when to grow *internally* (*build*), use *alliances* (*borrow*), or make *acquisitions* (*buy*). We then take a closer look at strategic alliances before studying mergers and acquisitions. We discuss alliances before acquisitions because alliances are smaller strategic commitments and thus are much more frequent. Moreover, in some cases, alliances may lead to acquisitions later, offering “try before you buy.” For example, before Disney acquired Pixar (for \$7.4 billion in 2006), the firms had a long-standing strategic alliance, where Pixar would develop computer-animated films that Disney would market and distribute. We conclude with *Implications for Strategic Leaders*, in which we discuss practical applications.

LO 9-1

Apply the build-borrow-or-buy framework to guide corporate strategy.

build-borrow-or-buy framework Conceptual model that aids firms in deciding whether to pursue internal development (*build*), enter a contractual arrangement or strategic alliance (*borrow*), or acquire new resources, capabilities, and competencies (*buy*).

9.1 How Firms Achieve Growth

After discussing in Chapter 8 why firms need to grow, the next question that arises is: *How do firms achieve growth?* Corporate executives have three options at their disposal to drive firm growth: organic growth through internal development, external growth through alliances, or external growth through acquisitions. Laurence Capron and Will Mitchell developed an insightful step-by-step decision model to guide managers in selecting the most appropriate corporate strategy vehicle.² Selecting the most suitable vehicle for corporate strategy in response to a specific strategic challenge also makes successful implementation more likely.

THE BUILD-BORROW-BUY FRAMEWORK

The **build-borrow-or-buy framework** provides a conceptual model that aids firms in deciding whether to pursue internal development (*build*), enter a contractual arrangement or strategic alliance (*borrow*), or acquire new resources, capabilities, and competencies (*buy*). Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage. Note that in the build-borrow-or-buy model, the term *resources* is defined broadly to include capabilities

and competencies (as in the *VRIO model* discussed in Chapter 4). Exhibit 9.1 shows the *build-borrow-or-buy* decision framework.

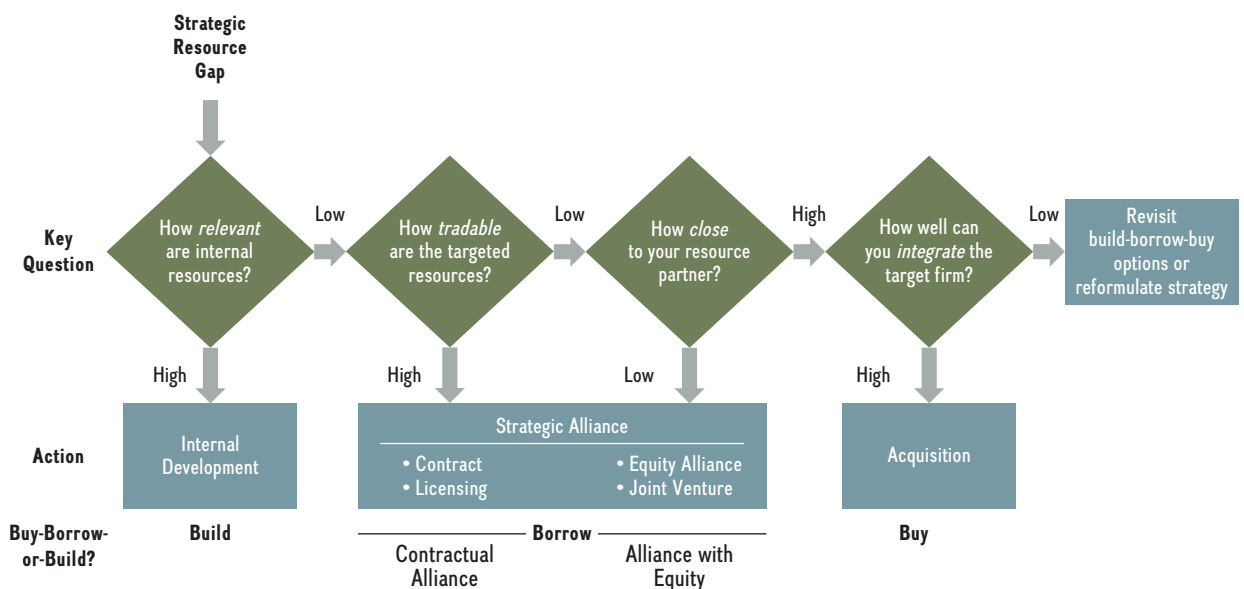
The starting point is the firm's identification of a strategic resource gap that will impede future growth. The resource gap is *strategic* because closing this gap is likely to lead to a competitive advantage. As discussed in Chapter 4, resources with the potential to lead to competitive advantage cannot be simply bought on the open market. Indeed, if any firm could readily buy this type of resource, its availability would negate its potential for competitive advantage. It would no longer be *rare*, a key condition for a resource to form the basis of competitive advantage. Moreover, resources that are *valuable*, *rare*, and *difficult to imitate* are often embedded deep within a firm, frequently making up a resource bundle that is hard to unplug whole or in part.

The options to close the strategic resource gap are, therefore, to build, borrow, or buy. *Build* in the build-borrow-buy framework refers to internal development; *borrow* refers to the use of strategic alliances; and *buy* refers to acquiring a firm. When acquiring a firm, you buy an entire "resource bundle," not just a specific resource. This resource bundle, if obeying VRIO principles and successfully integrated, can then form the basis of competitive advantage.

Exhibit 9.1 provides a schematic of the build-borrow-or-buy framework. In this approach strategic leaders must determine the degree to which certain conditions apply, either high or low, by responding to up to four questions sequentially before finding the best course. The questions cover issues of *relevancy*, *tradability*, *closeness*, and *integration*:

1. **Relevancy.** How *relevant* are the firm's existing internal resources to solving the resource gap?
2. **Tradability.** How *tradable* are the targeted resources that may be available externally?

EXHIBIT 9.1 / Guiding Corporate Strategy: The Build-Borrow-or-Buy Framework



SOURCE: Adapted from L. Capron and W. Mitchell (2012), *Build, Borrow, or Buy: Solving the Growth Dilemma* (Boston, MA: Harvard Business Review Press).

3. **Closeness.** How *close* do you need to be to your external resource partner?
4. **Integration.** How well can you *integrate* the targeted firm, should you determine you need to acquire the resource partner?

As shown in Exhibit 9.1, the answers to these questions lead to a recommended action or the next question. We'll review each in more depth.

1. HOW RELEVANT ARE THE FIRM'S EXISTING INTERNAL RESOURCES TO SOLVING THE RESOURCE GAP? The firm's strategic leaders start by asking whether the firm's internal resources are high or low in relevance. If the firm's internal resources are highly relevant to closing the identified gap, the firm should itself build the new resources needed through internal development.

But how does a strategic leader know whether the firm's resources are relevant in addressing a new challenge or opportunity? Firms evaluate the relevance of internal resources in two ways: they test whether resources are (1) *similar* to those the firm needs to develop and (2) *superior* to those of competitors in the targeted area.³ If *both* conditions are met, then the firm's internal resources are relevant and the firm should pursue internal development.

Let's look at both conditions. Strategic leaders are often misled by the first test because things that might appear similar at the surface are actually quite different deep down.⁴ Moreover, they tend to focus on the (known) similarities rather than on (unknown) differences. Strategic leaders often don't know how the resources needed for the existing and new business opportunity differ. An executive at a newspaper publisher such as *The New York Times* may conclude that the researching, reporting, writing, and editing activities done for a printed newspaper are similar to those done for an online one. Although the activities may be similar, they are also different because the underlying business model and technology for online publishing are radically different from that of traditional print media. Managing the community interactions of online publishing as well as applying data analytics to understand website traffic and reader engagement are also elements that are entirely new. To make the challenge even greater, online news reporting is required in real time, 24/7, 365 days a year. To make matters worse, old-line news companies are now competing with millions of so-called citizen journalists on social media, such as Twitter, which often have an edge on breaking news.⁵

The second test, determining whether your internal resources are *superior* to those of competitors in the targeted area, can best be assessed by applying the VRIO framework (see Exhibit 4.5). In the case of the print publisher, the answer to both questions is likely a "no." This implies that building the new resource through *internal* development is not an option. The firm then needs to consider *external*—borrow or buy—options. This then leads us to the next question.

2. HOW TRADABLE ARE THE TARGETED RESOURCES THAT MAY BE AVAILABLE EXTERNALLY? For external options, the firm needs to determine how tradable the targeted resources may be. The term *tradable* implies that the firm is able to source the resource externally through a contract that allows for the transfer of ownership or use of the resource. Short-term as well as long-term contracts, such as licensing or franchising, are a way to *borrow* resources from another company (see discussion in Chapter 8). In the biotechnology industry, some producers use licensing agreements to transfer knowledge and technology from the licensor's R&D to the licensee's manufacturing. Eli Lilly, for example, has commercialized several breakthrough biotech drugs using licensing agreements with new ventures. The implication is that if a resource is highly tradable, then the resource should be *borrowed* via a licensing agreement or other contractual agreement. If the resource in

question is not easily tradable, then the firm needs to consider either a deeper strategic alliance through an equity alliance or a joint venture, or an outright acquisition.

3. HOW CLOSE DO YOU NEED TO BE TO YOUR EXTERNAL RESOURCE PARTNER? Many times, firms are able to obtain the required resources to fill the strategic gap through more integrated strategic alliances such as equity alliances or joint ventures (see Exhibit 8.4) rather than through outright acquisition. Mergers and acquisitions are the most costly, complex, and difficult to reverse strategic option. This implies that only if extreme closeness to the resource partner is necessary to understand and obtain its underlying knowledge should M&A be considered the *buy* option. Regardless, the firm should always first consider *borrowing* the necessary resources through integrated strategic alliances before looking at M&A.

4. HOW WELL CAN YOU INTEGRATE THE TARGETED FIRM, SHOULD YOU DETERMINE YOU NEED TO ACQUIRE THE RESOURCE PARTNER? The final decision question using the build-borrow-buy lens is: *Can you integrate the target firm?* The list of post-integration failures, often due to cultural differences, is long. Multibillion-dollar failures include the Daimler-Chrysler integration, AOL and Time Warner, HP and Autonomy, and Bank of America and Merrill Lynch. More than cultural differences were involved in Microsoft's 2015 decision to write down \$7.6 billion in losses (or more than 80 percent) on its \$9.4 billion acquisition of Nokia some 15 months earlier. It's now up to Microsoft CEO Satya Nadella to decide how to compete in the mobile device arena after former CEO Steve Ballmer made a desperate gamble on acquiring the Finnish cell phone maker.⁶

Only if the three prior conditions (*low relevancy*, *low tradability*, and *high need for closeness*) shown in the decision tree in Exhibit 9.1 are met, should the firm's strategic leaders consider M&A: If the firm's internal resources are insufficient to *build*, and the resource needed to fill the strategic gap cannot be *borrowed* through a strategic alliance, and closeness to the resource partner is needed, then the final question to consider is whether the integration of the two firms using a merger or acquisition will be successful. In all other cases, the firms should consider finding a less costly *borrow* arrangement when *building* is not an option. Since strategic alliances are the less costly and more common tool to execute corporate strategy, we discuss alliances first before mergers and acquisitions. Per the build-borrow-buy decision framework, strategic alliances (*borrow*) also need to be considered before mergers and acquisitions (*buy*).

9.2 Strategic Alliances

Firms enter many types of alliances, from small contracts that have no bearing on a firm's competitiveness to multibillion-dollar joint ventures that can make or break the company. An alliance, therefore, qualifies as *strategic* only if it has the potential to affect a firm's competitive advantage.

Strategic alliances are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.⁷ The use of strategic alliances to implement corporate strategy has grown significantly in the past few decades, with thousands forming each year. As the speed of technological change and innovation has increased (see discussion in Chapter 7), firms have responded by entering more alliances. Globalization has also contributed to an increase in cross-border strategic alliances (see discussion in Chapter 10).

Strategic alliances are attractive for a number of reasons. They enable firms to achieve goals faster and at lower costs than going it alone. Strategic alliances may join

LO 9-2

Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

strategic alliances Voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

relational view of competitive advantage Strategic management framework that proposes that critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries.

complementary parts of a firm's value chain, such as R&D and marketing, or they may focus on joining the same value chain activities. In contrast to mergers and acquisitions, strategic alliances also allow firms to circumvent potential legal repercussions including potential lawsuits filed by U.S. federal agencies or the European Union.

A strategic alliance has the potential to help a firm gain and sustain a competitive advantage when it joins together resources and knowledge in a combination that obeys the VRIO principles (introduced in Chapter 4).⁸ The locus of competitive advantage is often not found within the individual firm but within a strategic partnership. According to this **relational view of competitive advantage**, critical resources and capabilities frequently are embedded in strategic alliances that span firm boundaries. Applying the VRIO framework, we know that the basis for competitive advantage is formed when a strategic alliance creates resource combinations that are valuable, rare, and difficult to imitate, and the alliance is organized appropriately to allow for value capture. In support of this perspective, over 80 percent of Fortune 1000 CEOs indicated in a survey that more than one-quarter of their firm's revenues were derived from strategic alliances.⁹

WHY DO FIRMS ENTER STRATEGIC ALLIANCES?

To affect a firm's competitive advantage, an alliance must promise a positive effect on the firm's economic value creation through increasing value and/or lowering costs (see discussion in Chapter 5). This logic is reflected in the common reasons firms enter alliances.¹⁰ They do so to

- Strengthen competitive position.
- Enter new markets.
- Hedge against uncertainty.
- Access critical complementary assets.
- Learn new capabilities.

STRENGTHEN COMPETITIVE POSITION. Firms frequently resort to strategic alliances to strengthen their competitive position. Firms can also use strategic alliances to change the industry structure in their favor.¹¹ Moreover, firms frequently use strategic alliances when competing in setting an industry standard (see discussion in Chapter 7). Strategy Highlight 9.1 shows how Tesla used alliances strategically to strengthen its competitive standing and to position itself advantageously in making battery-powered vehicles a serious contender for the future standard in car propulsion, eventually obsoleting internal combustion engines.

ENTER NEW MARKETS. Firms may use strategic alliances to enter new markets, either in terms of products and services or geography.¹²

Using a strategic alliance, HP and DreamWorks Animation SKG created the Halo Collaboration Studio, which makes virtual communication possible around the globe.¹³ Halo's conferencing technology gives participants the vivid sense that they are in the same room. The conference rooms of clients match, down to the last detail, giving participants the impression that they are sitting together at the same table. DreamWorks produced the computer-animated movie *Shrek 2* using this new technology for its meetings. People with different creative skills—script writers, computer animators, directors—though dispersed geographically, were able to participate as if in the same room, even seeing the work on each other's laptops. Use of the technology enabled faster decision making, enhanced productivity, reduced (or even eliminated) travel time and expense, and increased job

Strategy Highlight 9.1

How Tesla Used Alliances Strategically

Since its initial public offering in 2010, the electric-car manufacturer Tesla has had tremendous impact. Indeed, by 2017 it had become the most valuable car company in the United States, ahead of GM and Ford. One critical factor in the success of the California startup is the role played by Tesla's strategy involving alliances with larger, more established companies. Two key strategic alliances in particular—one with Daimler and the other with Toyota—were crucial to Tesla's early success. The Daimler partnership provided a much-needed cash injection; the Toyota partnership gave Tesla access to a world-class automobile manufacturing facility located near its headquarters in Palo Alto, California.

Initially, Tesla, which began selling its all-electric Roadster model in 2008, had neither a market nor legitimacy. Moreover, it was plagued with both thorny technical problems and cost overruns. Yet it managed to overcome these early challenges, in part by turning prospective rivals into alliance partners. In 2009, the year before its IPO, Tesla worked out the alliance with Daimler, whose roots in automobile engineering extend back to early days of the automobile powered by an internal combustion engine about 130 years ago. The deal provided Tesla with access to superior engineering expertise and a cash infusion of \$50 million, helping to save the company from potential bankruptcy.

The alliance with Toyota, signed the following year, brought other benefits. It enabled Tesla to buy the former New United Motor Manufacturing Inc. (NUMMI) factory in Fremont, California—created as a joint venture between Toyota and General Motors Corp. in 1984—and to learn large-scale, high-quality manufacturing from a pioneer of lean manufacturing. As it happened, the NUMMI plant was the only remaining large-scale car manufacturing plant in California, and some 25 miles from Tesla's Palo Alto headquarters. Without this factory, Tesla would not have been able to initiate production planning for its new Model 3, which received more than 350,000 preorders within three months of its announcement in March 2016.

In 2014, Tesla signed another strategic alliance—this one with Osaka-based Panasonic, the Japanese consumer electronics company and a world leader in battery technology. As Tesla tries to position itself in the business of sustainable and decentralized energy, the relationship with Panasonic is significant. The two companies are jointly investing in a new \$5 billion lithium-ion battery plant in Nevada. Tesla's ability to attract and manage leading companies in the automotive and other key industries as strategic alliance partners is an important part of its formula for success.

The decisions by Daimler, Toyota, and Panasonic to collaborate with Tesla highlight that individual companies may not need to own all of the resources, skills, and knowledge necessary to undertake key strategic growth initiatives.¹⁴

satisfaction. Neither HP nor DreamWorks would have been able to produce this technology breakthrough alone, but moving into the videoconferencing arena together via a strategic alliance allowed both partners to pursue related diversification. Moreover, HP's alliance with DreamWorks Animation SKG enabled HP to compete head on with Cisco's high-end videoconferencing solution, TelePresence.¹⁵ The HP and DreamWorks Animation SKG alliance was motivated by the desire to enter a new market, in terms of products and services offered, that neither could enter alone.

When entering new geographic markets, in some instances, governments such as Saudi Arabia or China may require that foreign firms have a local joint venture partner before doing business in their countries. These cross-border strategic alliances have both benefits and risks. While the foreign firm can benefit from local expertise and contacts, it is exposed to the risk that some of its proprietary know-how may be appropriated by the foreign partner. We will address such issues in Chapter 10 when studying global strategy.

HEDGE AGAINST UNCERTAINTY. In dynamic markets, strategic alliances allow firms to limit their exposure to uncertainty in the market.¹⁶ For instance, in the wake of the

biotechnology revolution, incumbent pharmaceutical firms such as Pfizer, Novartis, and Roche entered into hundreds of strategic alliances with biotech startups.¹⁷ These alliances allowed the big pharma firms to make small-scale investments in many of the new biotechnology ventures that were poised to disrupt existing market economics. In some sense, the pharma companies were taking *real options* in these biotechnology experiments, providing them with the right but not the obligation to make further investments when new drugs were introduced from the biotech companies.

real-options perspective Approach to strategic decision making that breaks down a larger investment decision into a set of smaller decisions that are staged sequentially over time.

A **real-options perspective** to strategic decision making breaks down a larger investment decision (such as whether to enter biotechnology or not) into a set of smaller decisions that are staged sequentially over time. This approach allows the firm to obtain additional information at predetermined stages. At each stage, after new information is revealed, the firm evaluates whether or not to make further investments. In a sense, a real option, which is the right, but not the obligation, to continue making investments, allows the firm to buy time until sufficient information for a go versus no-go decision is revealed. Once the new biotech drugs were a known quantity, the uncertainty was removed, and the incumbent firms could react accordingly.

For example, in 1990 the Swiss pharma company Roche initially invested \$2.1 billion in an equity alliance to purchase a controlling interest (greater than 50 percent) in the biotech startup Genentech. In 2009, after witnessing the success of Genentech's drug discovery and development projects in subsequent years, Roche spent \$47 billion to purchase the remaining minority interest in Genentech, making it a wholly owned subsidiary.¹⁸ Taking a wait-and-see approach by entering strategic alliances allows incumbent firms to buy time and wait for the uncertainty surrounding the market and technology to fade. Many firms in fast-moving markets subscribe to this rationale. Waiting can also be expensive, however. To acquire the remaining less than 50 percent of Genentech some 20 years after its initial investment required a price that was some 24 times higher than the initial investment, as uncertainty settled and the biotech startup turned out to be hugely successful. Besides biotechnology, the use of a *real-options perspective* in making strategic investments has also been documented in nanotechnology, semiconductors, and other dynamic markets.¹⁹

ACCESS CRITICAL COMPLEMENTARY ASSETS. The successful commercialization of a new product or service often requires complementary assets such as marketing, manufacturing, and after-sale service.²⁰ In particular, new firms are in need of complementary assets to complete the value chain from upstream innovation to downstream commercialization. This implies that a new venture that has a core competency in R&D, for example, will need to access distribution channels and marketing expertise to complete the value chain. Building downstream complementary assets such as marketing and regulatory expertise or a sales force is often prohibitively expensive and time-consuming, and thus frequently not an option for new ventures. Strategic alliances allow firms to match complementary skills and resources to complete the value chain. Moreover, licensing agreements of this sort allow the partners to benefit from a division of labor, allowing each to efficiently focus on its core competency.

co-opetition Cooperation by competitors to achieve a strategic objective.

learning races Situations in which both partners in a strategic alliance are motivated to form an alliance for learning, but the rate at which the firms learn may vary.

LEARN NEW CAPABILITIES. Firms also enter strategic alliances because they are motivated by the desire to learn new capabilities from their partners.²¹ When the collaborating firms are also competitors, *co-opetition* ensues.²² **Co-opetition** is a portmanteau describing cooperation by competitors. They may cooperate to create a larger pie but then might compete about how the pie should be divided. Such co-opetition can lead to **learning races**

in strategic alliances,²³ a situation in which both partners are motivated to form an alliance for learning, but the rate at which the firms learn may vary. The firm that learns faster and accomplishes its goal more quickly has an incentive to exit the alliance or, at a minimum, to reduce its knowledge sharing. Since the cooperating firms are also competitors, learning races can have a positive effect on the winning firm's competitive position vis-à-vis its alliance partner.

NUMMI (New United Motor Manufacturing, Inc.) was the first joint venture in the U.S. automobile industry, formed between GM and Toyota in 1984. Recall from Chapter 8 that joint ventures are a special type of a strategic alliance in which two partner firms create a third, jointly owned entity. In the NUMMI joint venture, each partner was motivated to learn new capabilities: GM entered the equity-based strategic alliance to learn the lean manufacturing system pioneered by Toyota to produce high-quality, fuel-efficient cars at a profit. Toyota entered the alliance to learn how to implement its lean manufacturing program with an American work force. NUMMI was a test-run for Toyota before building fully owned *greenfield plants* (new manufacturing facilities) in Alabama, Indiana, Kentucky, Mississippi, Texas, and West Virginia. In this 25-year history, GM and Toyota built some 7 million high-quality cars at the NUMMI plant. In fact, NUMMI was transformed from worst performer (under GM ownership before the joint venture) to GM's highest-quality plant in the United States. In the end, as part of GM's bankruptcy reorganization during 2009–2010, it pulled out of the NUMMI joint venture. Toyota later sold the NUMMI plant to Tesla (as mentioned in Strategy Highlight 9.1).

The joint venture between GM and Toyota can be seen as a learning race. Who won? Strategy scholars argue that Toyota was faster in accomplishing its alliance goal—learning how to manage U.S. labor—because of its limited scope.²⁴ Toyota had already perfected lean manufacturing; all it needed to do was learn how to train U.S. workers in the method and transfer this knowledge to its subsidiary plants in the United States. On the other hand, GM had to learn a completely new production system. GM was successful in transferring lean manufacturing to its newly created Saturn brand (which was discontinued in 2010 as part of GM's reorganization), but it had a hard time implementing lean manufacturing in its *existing* plants. These factors suggest that Toyota won the learning race with GM, which in turn helped Toyota gain and sustain a competitive advantage over GM in the U.S. market.

Also, note that different motivations for forming alliances are not necessarily independent and can be intertwined. For example, firms that collaborate to access critical complementary assets may also want to learn from one another to subsequently pursue vertical integration. In sum, alliance formation is frequently motivated by leveraging economies of scale, scope, specialization, and learning.

GOVERNING STRATEGIC ALLIANCES

In Chapter 8, we showed that strategic alliances lie in the middle of the make-or-buy continuum (see Exhibit 8.4). Alliances can be governed by the following mechanisms:²⁵

- Non-equity alliances
- Equity alliances
- Joint ventures

Exhibit 9.2 provides an overview of the key characteristics of the three alliance types, including their advantages and disadvantages.

LO 9-3

Describe three alliance governance mechanisms and evaluate their pros and cons.

EXHIBIT 9.2 / Key Characteristics of Different Alliance Types

Alliance Type	Governance Mechanism	Frequency	Type of Knowledge Exchanged	Pros	Cons	Examples
Non-equity (supply, licensing, and distribution agreements)	Contract	Most common	Explicit	• Flexible • Fast • Easy to initiate and terminate	• Weak tie • Lack of trust and commitment	• Genentech-Lilly (exclusive) licensing agreement for Humulin • Microsoft-IBM (nonexclusive) licensing agreement for MS-DOS
Equity (purchase of an equity stake or corporate venture capital investment, or investment in kind such as a plant and equipment)	Equity investment	Less common than non-equity alliances, but more common than joint ventures	Explicit; exchange of tacit knowledge possible	• Stronger tie • Trust and commitment can emerge • Window into new technology (option value)	• Less flexible • Slower • Can entail significant investments	• Renault-Nissan alliance based on cross equity holdings, with Renault owning 43.4% in Nissan; and Nissan owning 15% in Renault • Roche's equity investment in Genentech (prior to full integration)
Joint venture (JV)	Creation of new entity by two or more parent firms	Least common	Both tacit and explicit knowledge exchanged	• Strongest tie • Trust and commitment likely to emerge • May be required by institutional setting	• Can entail long negotiations and significant investments • Long-term solution • JV managers have double reporting lines (2 bosses)	• Hulu, owned by NBC (30%), Fox (30%), Disney-ABC (30%), and Turner Broadcasting System (10%) • The A++ trans-Atlantic joint venture, owned by United Airlines, Lufthansa, and Air Canada

non-equity alliance Partnership based on contracts between firms.

NON-EQUITY ALLIANCES. The most common type of alliance is a **non-equity alliance**, which is based on contracts between firms. The most frequent forms of non-equity alliances are *supply agreements*, *distribution agreements*, and *licensing agreements*. As suggested by their names, these contractual agreements are vertical strategic alliances,

connecting different parts of the industry value chain. In a non-equity alliance, firms tend to share **explicit knowledge**—knowledge that can be codified. Patents, user manuals, fact sheets, and scientific publications are all ways to capture explicit knowledge, which concerns the notion of *knowing about* a certain process or product.

explicit knowledge
Knowledge that can be codified; concerns knowing about a process or product.

Licensing agreements are contractual alliances in which the participants regularly exchange codified knowledge. The biotech firm Genentech licensed its newly developed drug Humulin (human insulin) to the pharmaceutical firm Eli Lilly for manufacturing, facilitating approval by the Food and Drug Administration (FDA), and distribution. This partnership was an example of a vertical strategic alliance: One partner (Genentech) was positioned upstream in the industry value chain focusing on R&D, while the other partner (Eli Lilly) was positioned downstream focusing on manufacturing and distribution. This type of vertical arrangement is often described as a hand-off from the upstream partner to the downstream partner and is possible because the underlying knowledge is largely explicit and can be easily codified. When Humulin reached the market, it was the first approved genetically engineered human therapeutic drug worldwide.²⁶ Subsequently, Humulin became a billion-dollar blockbuster drug.

Because of their contractual nature, non-equity alliances are flexible and easy to initiate and terminate. However, because they can be temporary in nature, they also sometimes produce weak ties between the alliance partners, which can result in a lack of trust and commitment.

EQUITY ALLIANCES. In an **equity alliance**, at least one partner takes partial ownership in the other partner. Equity alliances are less common than contractual, non-equity alliances because they often require larger investments. Because they are based on partial ownership rather than contracts, equity alliances are used to signal stronger commitments. Moreover, equity alliances allow for the sharing of **tacit knowledge**—knowledge that cannot be codified.²⁷ Tacit knowledge concerns *knowing how* to do a certain task. It can be acquired only through actively participating in the process. In an equity alliance, therefore, the partners frequently exchange personnel to make the acquisition of tacit knowledge possible.

equity alliance
Partnership in which at least one partner takes partial ownership in the other.

tacit knowledge
Knowledge that cannot be codified; concerns knowing how to do a certain task and can be acquired only through active participation in that task.

Toyota used an equity alliance with Tesla, a designer and maker of electric cars (featured in ChapterCase 1 and Strategy Highlight 9.1), to learn new knowledge and gain a window into new technology. In 2010, Toyota made a \$50 million equity investment in the California startup. In the same year, Tesla purchased the NUMMI plant in Fremont, California, where it now manufactures its Models S, X, and 3. Tesla CEO Elon Musk stated, “The Tesla factory effectively leverages an ideal combination of hardcore Silicon Valley engineering talent, traditional automotive engineering talent, and the proven Toyota production system.” Toyota in turn hopes to infuse its company with Tesla’s entrepreneurial spirit. Toyota President Akio Toyoda commented, “By partnering with Tesla, my hope is that all Toyota employees will recall that ‘venture business spirit’ and take on the challenges of the future.” Toyoda hoped that a transfer of tacit knowledge would occur, in which Tesla’s entrepreneurial spirit would reinvigorate Toyota.²⁸ This equity-based learning race ended in 2014 when Toyota sold its stake in Tesla.²⁹ The Japanese automaker is shifting away from electric cars, renewing its focus on hybrid vehicles and exploring fuel-cell technology.

Another governance mechanism that falls under the broad rubric of equity alliances is **corporate venture capital (CVC)** investments, which are equity investments by established firms in entrepreneurial ventures.³⁰ The value of CVC investments is estimated to be in the double-digit billion-dollar range each year. Larger firms frequently have dedicated CVC units, such as Google Ventures, Siemens Venture Capital, Kaiser Permanente Ventures, and Johnson & Johnson Development Corp. Rather than hoping primarily for

corporate venture capital (CVC) Equity investments by established firms in entrepreneurial ventures; CVC falls under the broader rubric of equity alliances.

financial gains, as venture capitalists traditionally do, CVC investments create real options in terms of gaining access to new, and potentially disruptive, technologies.³¹ Strategy scholars find that CVC investments have a positive impact on value creation for the investing firm, especially in high-tech industries such as semiconductors, computing, and the medical-device sector.³²

Taken together, equity alliances tend to produce stronger ties and greater trust between partners than non-equity alliances do. They also offer a window into new technology that, like a real option, can be exercised if successful or abandoned if not promising. Equity alliances are frequently stepping-stones toward full integration of the partner firms either through a merger or an acquisition. Essentially, they are often used as a “try before you buy” strategic option.³³ The downside of equity alliances is the amount of investment that can be involved, as well as a possible lack of flexibility and speed in putting together and reaping benefits from the partnership.

JOINT VENTURES. A *joint venture* (JV) is a standalone organization created and jointly owned by two or more parent companies (as discussed in Chapter 8). For example, Hulu (a video-on-demand service) is jointly owned by NBC, Disney-ABC, Fox, and Turner Broadcast System (TBS). Since partners contribute equity to a joint venture, they are making a long-term commitment. Exchange of both explicit and tacit knowledge through interaction of personnel is typical. Joint ventures are also frequently used to enter foreign markets where the host country requires such a partnership to gain access to the market in exchange for advanced technology and know-how. In terms of frequency, joint ventures are the least common of the three types of strategic alliances.

The advantages of joint ventures are the strong ties, trust, and commitment that can result between the partners. However, they can entail long negotiations and significant investments. If the alliance doesn’t work out as expected, undoing the JV can take some time and involve considerable cost. A further risk is that knowledge shared with the new partner could be misappropriated by opportunistic behavior. Finally, any rewards from the collaboration must be shared between the partners.

LO 9-4

Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

alliance management capability A firm’s ability to effectively manage three alliance-related tasks concurrently: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.

ALLIANCE MANAGEMENT CAPABILITY

Strategic alliances create a paradox for managers. Although alliances appear to be necessary to compete in many industries, between 30 and 70 percent of all strategic alliances do not deliver the expected benefits, and are considered failures by at least one alliance partner.³⁴ Given the high failure rate, effective alliance management is critical to gaining and sustaining a competitive advantage, especially in high-technology industries.³⁵

Alliance management capability is a firm’s ability to effectively manage three alliance-related tasks concurrently, often across a portfolio of many different alliances (see Exhibit 9.3):³⁶

- Partner selection and alliance formation.
- Alliance design and governance.
- Post-formation alliance management.

PARTNER SELECTION AND ALLIANCE FORMATION. When making the business case for an alliance, the expected benefits of the alliance must exceed its costs. When one or more of the five reasons for alliance formation are present—to strengthen competitive position, enter new markets, hedge against uncertainty, access critical complementary resources, or learn new capabilities—the firm must select the best possible alliance partner. Partner

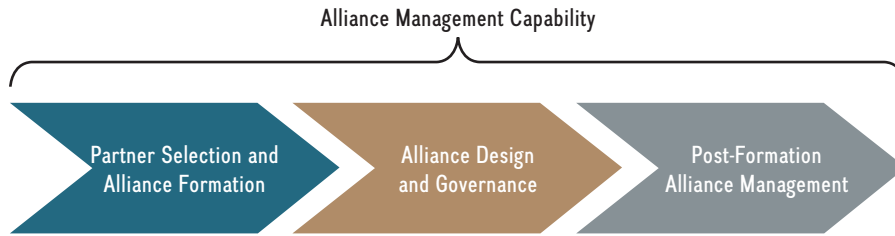


EXHIBIT 9.3 /
Alliance Management
Capability

compatibility and partner commitment are necessary conditions for successful alliance formation.³⁷ *Partner compatibility* captures aspects of cultural fit between different firms. *Partner commitment* concerns the willingness to make available necessary resources and to accept short-term sacrifices to ensure long-term rewards.

ALLIANCE DESIGN AND GOVERNANCE. Once two or more firms agree to pursue an alliance, managers must then design the alliance and choose an appropriate governance mechanism from among the three options: non-equity contractual agreement, equity alliances, or joint venture. For example, in a study of over 640 alliances, researchers found that the joining of specialized complementary assets increases the likelihood that the alliance is governed hierarchically. This effect is stronger in the presence of uncertainties concerning the alliance partner as well as the envisioned tasks.³⁸

In addition to the formal governance mechanisms, *interorganizational trust* is a critical dimension of alliance success.³⁹ Because all contracts are necessarily incomplete, trust between the alliance partners plays an important role for effective post-formation alliance management. Effective governance, therefore, can be accomplished only by skillfully combining formal and informal mechanisms.

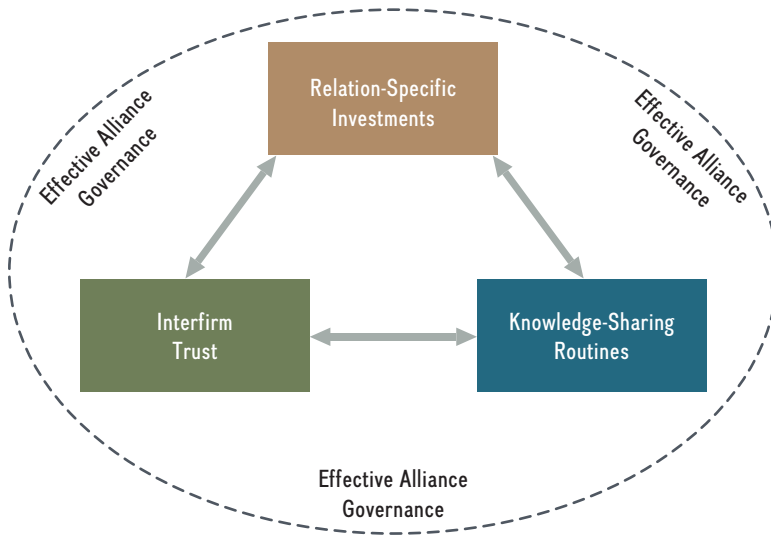
POST-FORMATION ALLIANCE MANAGEMENT. The third phase in a firm's alliance management capability concerns the ongoing management of the alliance. To be a source of competitive advantage, the partnership needs to create resource combinations that obey the VRIO criteria. As shown in Exhibit 9.4, this can most likely be accomplished if the alliance partners *make relation-specific investments*, *establish knowledge-sharing routines*, and *build interfirm trust*.⁴⁰

Trust is a critical aspect of any alliance. Interfirm trust entails the expectation that each alliance partner will behave in good faith and develop norms of reciprocity and fairness.⁴¹ Such trust helps ensure that the relationship survives and thereby increases the possibility of meeting the intended goals of the alliance. Interfirm trust is also important for fast decision making.⁴² Several firms such as Eli Lilly, HP, Procter & Gamble, and IBM compete to obtain trustworthy reputations in order to become the alliance "partner of choice" for small technology ventures, universities, and individual inventors.

Indeed, the systematic differences in firms' alliance management capability can be a source of competitive advantage.⁴³ But how do firms build alliance management capability? The answer is to build capability through repeated experiences over time. In support of this idea, several empirical studies have shown that firms move down the learning curve and become better at managing alliances through repeated alliance exposure.⁴⁴

The "learning-by-doing" approach has value for small ventures in which a few key people coordinate most of the firms' activities.⁴⁵ However, there are clearly limitations for larger companies. Conglomerates such as ABB, GE, Philips, or Siemens are engaged in hundreds of alliances simultaneously. In fact, if alliances are not managed from a

EXHIBIT 9.4 / How to Make Alliances Work



SOURCE: Adapted from J.H. Dyer and H. Singh (1998), "The relational view: Cooperative strategy and the sources of intraorganizational advantage," *Academy of Management Review* 23: 660–679.

portfolio perspective at the corporate level, serious negative repercussions can emerge.⁴⁶ Groupe Danone, a large French food conglomerate, lost its leading position in the highly lucrative and fast-growing Chinese market because its local alliance partner, Hangzhou Wahaha Group, terminated the long-standing alliance.⁴⁷ Wahaha accused different Danone business units of subsequently setting up partnerships with other Chinese firms that were a direct competitive threat to Wahaha. This example makes it clear that although alliances are important pathways by which to pursue business-level strategy, they are best managed at the corporate level.

To accomplish effective alliance management, strategy scholars suggest that firms create a *dedicated alliance function*,⁴⁸ led by a vice president or

director of alliance management and endowed with its own resources and support staff. The dedicated alliance function should be given the tasks of coordinating all alliance-related activity in the entire organization, taking a corporate-level perspective. It should serve as a repository of prior experience and be responsible for creating processes and structures to teach and leverage that experience and related knowledge throughout the rest of the organization across all levels. Research shows that firms with a dedicated alliance function are able to create value from their alliances above and beyond what could be expected based on experience alone.⁴⁹

Pharmaceutical company Eli Lilly is an acknowledged leader in alliance management.⁵⁰ Lilly's Office of Alliance Management, led by a director and endowed with several full-time positions, manages its far-flung alliance activity across all hierarchical levels and around the globe. Lilly's process prescribes that each alliance is managed by a three-person team: an alliance champion, alliance leader, and alliance manager.

- The *alliance champion* is a senior, corporate-level executive responsible for high-level support and oversight. This senior manager is also responsible for making sure that the alliance fits within the firm's existing alliance portfolio and corporate-level strategy.
- The *alliance leader* has the technical expertise and knowledge needed for the specific technical area and is responsible for the day-to-day management of the alliance.
- The *alliance manager*, positioned within the Office of Alliance Management, serves as an alliance process resource and business integrator between the two alliance partners and provides alliance training and development, as well as diagnostic tools.

Some companies are also able to leverage the relational capabilities obtained through managing alliance portfolios into a successful acquisition strategy.⁵¹ Eli Lilly has an entire department at the corporate level devoted to managing its alliance portfolio. Following up on an earlier 50/50 joint venture formed with Icos, maker of the \$1 billion-plus erectile-dysfunction drug Cialis, Lilly acquired Icos in 2007. Just a year later, Eli Lilly outmaneuvered Bristol-Myers Squibb to acquire biotech venture ImClone for \$6.5 billion. ImClone

discovered and developed the cancer-fighting drug Erbitux, also a \$1 billion blockbuster in terms of annual sales. The acquisition of these two smaller biotech ventures allowed Lilly to address its problem of an empty drug pipeline.⁵²

9.3 Mergers and Acquisitions

A popular vehicle for executing corporate strategy is mergers and acquisitions (M&A). Hundreds of mergers and acquisitions occur each year, with a cumulative value in the trillions of dollars.⁵³ Although the terms are often used interchangeably, and usually in tandem, mergers and acquisitions are, by definition, distinct from each other. A **merger** describes the joining of two independent companies to form a *combined entity*. Mergers tend to be friendly; in mergers, the two firms agree to join in order to create a combined entity. In the live event-promotion business, for example, Live Nation merged with Ticketmaster.

An **acquisition** describes the purchase or takeover of one company by another. Acquisitions can be friendly or unfriendly. For example, Disney's acquisition of Pixar, for example, was a friendly one, in which both management teams believed that joining the two companies was a good idea. When a target firm does not want to be acquired, the acquisition is considered a **hostile takeover**. British telecom company Vodafone's acquisition of Germany-based Mannesmann, a diversified conglomerate with holdings in telephony and internet services, at an estimated value of \$150 billion, was a hostile one. It was also the largest takeover in corporate history.

In defining mergers and acquisitions, size can matter as well. The combining of two firms of comparable size is often described as a merger even though it might in fact be an acquisition. For example, the integration of Daimler and Chrysler was pitched as a merger, though in reality Daimler acquired Chrysler, and later sold it. After emerging from bankruptcy restructuring, Chrysler is now majority-owned by Fiat, an Italian auto manufacturer.

In contrast, when large, incumbent firms such as GE, Cisco, or Microsoft buy start-up companies, the transaction is generally described as an acquisition. Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions*, or M&A.

WHY DO FIRMS MERGE WITH COMPETITORS?

In contrast to vertical integration, which concerns the number of activities a firm participates in up and down the industry value chain (as discussed in Chapter 8), **horizontal integration** is the process of merging with a competitor at the same stage of the industry value chain. Horizontal integration is a type of corporate strategy that can improve a firm's strategic position in a single industry. As a rule of thumb, firms should go ahead with horizontal integration (i.e., acquiring a competitor) *if the target firm is more valuable inside the acquiring firm than as a continued standalone company*. This implies that the net value creation of a horizontal acquisition must be positive to aid in gaining and sustaining a competitive advantage.

An industry-wide trend toward horizontal integration leads to industry consolidation. In particular, competitors in the same industry such as airlines, banking, telecommunications, pharmaceuticals, or health insurance frequently merge to respond to changes in their external environment and to change the underlying industry structure in their favor.

There are three main benefits to a horizontal integration strategy:

- Reduction in competitive intensity.
- Lower costs.
- Increased differentiation.

LO 9-5

Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

merger The joining of two independent companies to form a combined entity.

acquisition The purchase or takeover of one company by another; can be friendly or unfriendly.

hostile takeover Acquisition in which the target company does not wish to be acquired.

LO 9-6

Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

horizontal integration The process of merging with competitors, leading to industry consolidation.

EXHIBIT 9.5 /

Sources of Value
Creation and Costs in
Horizontal Integration

Corporate Strategy	Sources of Value Creation (V)	Sources of Costs (C)
Horizontal integration through M&A	• Reduction in competitive intensity • Lower costs • Increased differentiation	• Integration failure • Reduced flexibility • Increased potential for legal repercussions

Exhibit 9.5 previews the sources of value creation and costs in horizontal integration, which we discuss next.

REDUCTION IN COMPETITIVE INTENSITY. Looking through the lens of Porter's five forces model with a focus on rivalry among competitors (introduced in Chapter 3), horizontal integration changes the underlying industry structure in favor of the surviving firms. Excess capacity is taken out of the market, and competition tends to decrease as a consequence of horizontal integration, assuming no new entrants. As a whole, the industry structure becomes more consolidated and potentially more profitable. If the surviving firms find themselves in an oligopolistic industry structure and maintain a focus on non-price competition (i.e., focus on R&D spending, customer service, or advertising), the industry can indeed be quite profitable, and rivalry would likely decrease among existing firms. The wave of recent horizontal integration in the U.S. airline industry, for example, provided several benefits to the surviving carriers. By reducing excess capacity, the mergers between Delta and Northwest Airlines, United Airlines and Continental, Southwest and AirTran, and American and US Airways lowered competitive intensity in the industry overall.

Horizontal integration can favorably affect several of Porter's five forces for the surviving firms: strengthening bargaining power vis-à-vis suppliers and buyers, reducing the threat of entry, and reducing rivalry among existing firms. Because of the potential to reduce competitive intensity in an industry, government authorities such as the Federal Trade Commission (FTC) in the United States and/or the European Commission usually must approve any large horizontal integration activity. Industry dynamics, however, are in constant flux as new competitors emerge and others fall by the wayside.

In 2005, for example, the FTC did not approve the proposed merger between Staples and Office Depot, arguing that the remaining industry would have only two competitors, with Office Max being the other. Staples and Office Depot argued that the market for office supplies needed to be defined more broadly to include large retailers such as Walmart and Target. The U.S. courts sided with the FTC, which argued that the prices for end consumers would be significantly higher if the market had only two category killers.⁵⁴ A few years later, however, the competitive landscape had shifted further as Walmart and Amazon had emerged as ferocious competitors offering rock-bottom prices for office supplies. Subsequently, in 2013, the FTC approved the merger between Staples and Office Max. Just two years later, the FTC also approved the merger between the now much larger Staples and Office Depot.⁵⁵

LOWER COSTS. Firms use horizontal integration to lower costs through economies of scale and to enhance their economic value creation, and in turn their performance.⁵⁶ In industries that have high fixed costs, achieving economies of scale through large output is critical in lowering costs. The dominant pharmaceutical companies such as Pfizer, Roche, and Novartis, for example, maintain large sales forces ("detail people") who call on doctors and hospitals to promote their products. These specialized sales forces often number 10,000 or more and thus are a significant fixed cost to the firms, even though part of their

compensation is based on commissions. Maintaining such a large and sophisticated sales force (many with MBAs) is costly if the firm has only a few drugs it can show the doctor. As a rule of thumb, if a pharma company does not possess a blockbuster drug that brings in more than \$1 billion in annual revenues, it cannot maintain its own sales force.⁵⁷ When existing firms such as Pfizer and Wyeth merge, they join their drug pipelines and portfolios of existing drugs. They are likely to have one sales force for the combined portfolio, consequently reducing the size of the sales force and lowering the overall cost of distribution.

INCREASED DIFFERENTIATION. Horizontal integration through M&A can help firms strengthen their competitive positions by increasing the differentiation of their product and service offerings. In particular, horizontal integration can do this by filling gaps in a firm's product offering, allowing the combined entity to offer a complete suite of products and services.

As an example, Disney acquired Marvel for \$4 billion in 2009. This acquisition certainly allowed Disney to further differentiate its product offering as an entire new lineup of superheroes was joining Mickey's family, besides being able to offer Marvel superhero themed-rides and merchandise such as clothing (T-shirts, PJs, etc.) and toys. The Marvel acquisition passed an important test of value creation because Marvel is seen as more valuable inside Disney than outside Disney.⁵⁸ Because of economies of scope and economies of scale, Marvel is becoming more valuable inside Disney than as a standalone enterprise. The same argument could be made for other recent Disney acquisitions, including Pixar (acquired for \$7.4 billion in 2006) and Lucasfilm (acquired for \$4 billion in 2012).

LO 9-7

Explain why firms engage in acquisitions.

WHY DO FIRMS ACQUIRE OTHER FIRMS?

When first defining the terminology at the beginning of the chapter, we noted that an *acquisition* describes the purchase or takeover of one company by another. Why do firms make acquisitions? Three main reasons stand out:

- To gain access to new markets and distribution channels.
- To gain access to a new capability or competency.
- To preempt rivals.

TO GAIN ACCESS TO NEW MARKETS AND DISTRIBUTION CHANNELS. Firms may resort to acquisitions when they need to overcome entry barriers into markets they are currently not competing in or to access new distribution channels. Strategy Highlight 9.2 discusses Kraft's history with aggressive acquisitions, both successful and otherwise, in this regard.

Firms often resort to M&A to obtain new capabilities or competencies. To strengthen its capabilities in server systems and equipment and to gain access to the capability of designing mobile chips for the internet of things (the concept that everyday objects such as cell phones, wearable devices, temperature controls, household appliances, cars, etc., have network connectivity, allowing them to send and receive data), Intel acquired Altera for \$17 billion in 2015.⁵⁹

TO PREEMPT RIVALS. Sometimes firms may acquire promising startups not only to gain access to a new capability or competency, but also to preempt rivals from doing so. Let's look at the acquisitions made by two of the leading internet companies: Facebook and Alphabet's Google.⁶⁰

To preempt rivals Facebook spent more than \$25 billion since 2012 buying promising startups. It acquired, among others, Instagram, a photo- and video-sharing site, for \$1 billion in 2012. Facebook then went on to buy the text messaging service startup

Strategy Highlight 9.2

Kraft's Specialty: Hostile Takeovers

One example of a firm that pursues acquisitions aggressively is Kraft, a trait that can be traced through the years. In 2010, Kraft Foods bought UK-based Cadbury PLC for close to \$20 billion in a hostile takeover. Unlike the more diversified food-products company Kraft, Cadbury was focused solely on candy and gum. Hailing to 1824, Cadbury established itself in markets across the globe, in concert with the British Empire.

Kraft was attracted to Cadbury due to its strong position in fast-growing countries such as India, Egypt, and Thailand and in many Latin American markets. Cadbury held 70 percent of the market share for chocolate in India, with more than 1 billion people. Children there specifically ask for "Cadbury chocolate" instead of just plain "chocolate." It is difficult for outsiders like Kraft to break into emerging economies because earlier entrants have developed and perfected their distribution systems to meet the needs of millions of small, independent vendors. To secure a strong strategic position in these fast-growing emerging markets, therefore, Kraft felt that horizontal integration with Cadbury was critical. Kraft continues to face formidable competitors in global markets, including Nestlé and Mars, both of which are especially strong in China.

We can see Kraft's approach even through its divisions. To focus its different strategic business units more effectively and to reduce costs, Kraft Foods restructured in 2012. It separated its North American grocery-food business from its global snack-food and candy business (including Oreos and Cadbury chocolate), which is now Mondelez International. In 2015, Kraft Foods merged with Heinz (owned by Warren Buffett's Berkshire Hathaway and 3G Capital, a Brazilian hedge fund)

in a \$37 billion merger, creating the fifth-largest food company in the world, behind Nestlé, Mondelez, PepsiCo, and Unilever.

In the U.S. market, the Cadbury acquisition allows Mondelez greater access to convenience stores, gives it a new distribution channel, and opens a market for it that is growing fast and tends to have high profit margins. Mondelez, which does not directly compete in the United States, licenses its famous Oreo cookie to its subsidiary Nabisco.

Moreover, Mondelez licenses the sale of Cadbury chocolate to The Hershey Co., the largest U.S. chocolate manufacturer.

Hershey's main strategic focus is squarely on its home market. With the U.S. population growing slowly and becoming more health-conscious, however, Hershey decided in 2013 to enter the Chinese market, the world's fastest-growing candy market. Since its founding in 1894, Hershey's entry into China is the company's first product launch outside the United States. Hershey's sales growth in China, however, has been disappointing so far. Combined with little or no growth in the United States, Hershey had to cut jobs in 2015.

Inheriting a penchant for hostile takeovers from its parent Kraft Foods, Mondelez saw an opportunity. Spotting a weakness in the Hershey Co., Mondelez made an unsolicited takeover offer to buy the U.S. chocolate maker for some \$23 billion. The goal was to create the world's largest candymaker. But Hershey's board rebuffed the Mondelez takeover bid unanimously. The Hershey Co. is owned by the Hershey Trust, which was established by Milton Hershey some 125 years ago. The trust's main beneficiary is a school for underprivileged children in Hershey, Pennsylvania, the hometown of the namesake company.

The dominant trait of a preference for hostile takeovers inherited from its progenitor also became apparent in 2017



A "Cadbury loyalist" vocally opposing Kraft's acquisition of a company with symbolic value in the United Kingdom.

©John HARRIS/REPORT DIGITAL-REA/Redux

when Kraft Heinz made a whopping \$143 hostile takeover bid for Unilever, a British-Dutch consumer goods company. The intent was to merge the world's two largest packaged-food companies. Unilever CEO Paul Polman, however, made it

clear that the multinational with a strong focus on corporate social responsibility was not interested in pursuing any merger talks with Kraft Heinz.⁶¹

WhatsApp for \$22 billion in 2014, making it one of the largest tech acquisitions ever. In the same year, Facebook paid \$2 billion to acquire Oculus, a virtual reality (VR) firm.

Alphabet's Google has also made a string of acquisitions of new ventures to preempt rivals. In 2006, Google bought YouTube, the video-sharing website, for \$1.65 billion. Google engaged in a somewhat larger acquisition when it bought Motorola's cell phone unit for \$12.5 billion in 2011. This was done to gain access to Motorola's valuable patent holdings in mobile technology. Google later sold the cell phone unit to Lenovo, while retaining Motorola's patents. In 2013, Google purchased the Israeli start-up company Waze for \$1 billion. Google acquired Waze to gain access to a new capability and to prevent rivals from gaining access. Waze's claim to fame is its interactive mobile map app. Google is already the leader in online maps and wanted to extend this capability to mobile devices. Perhaps even more importantly, Google's intent was to preempt Apple and Facebook from buying Waze. Apple and Facebook are each comparatively weaker than Google in the increasingly important interactive mobile map and information services segment. In 2014, Google purchased the UK-based technology startup DeepMind for \$625 million to enhance its competitive position in artificial intelligence. Moreover, this move also prevented others such as Facebook or Amazon from acquiring DeepMind.

M&A AND COMPETITIVE ADVANTAGE

Do mergers and acquisitions create competitive advantage? Despite their popularity, the answer, surprisingly, is that in most cases they do not. In fact, the M&A performance track record is rather mixed. Many mergers destroy shareholder value because the anticipated synergies never materialize.⁶² If value is created, it generally accrues to the shareholders of the firm that was taken over (the acquiree), because acquirers often pay a premium when buying the target company.⁶³ Indeed, sometimes companies get involved in a bidding war for an acquisition; the winner may end up with the prize but may have overpaid for the acquisition—thus falling victim to the *winner's curse*.

Given that mergers and acquisitions, *on average*, destroy rather than create shareholder value, why do we see so many mergers? Reasons include:

- Principal–agent problems.
- The desire to overcome competitive disadvantage.
- Superior acquisition and integration capability.

PRINCIPAL-AGENT PROBLEMS. When discussing diversification in the previous chapter, we noted that some firms diversify through acquisitions due to principal–agent problems (see Chapter 8 discussion of managerial motives behind firm growth).⁶⁴ Managers,

LO 9-8

Evaluate whether mergers and acquisitions lead to competitive advantage.



Sometimes the combined value of two companies is less than the value of each company separately.

Oatmeal: ©McGraw-Hill Education/Mark Dierker, photographer; Snapple: ©George W. Bailey/Shutterstock.com RF

managerial hubris A form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.

as agents, are supposed to act in the best interest of the principals, the shareholders. However, managers may have incentives to grow their firms through acquisitions—not for anticipated shareholder value appreciation, but to build a larger empire, which is positively correlated with prestige, power, and pay. Besides providing higher compensation and more corporate perks, a larger organization may also provide more job security, especially if the company pursues unrelated diversification.

A related problem is **managerial hubris**, a form of self-delusion in which managers convince themselves of their superior skills in the face of clear evidence to the contrary.⁶⁵ Managerial hubris comes in two forms:

1. Managers of the acquiring company convince themselves that they are able to manage the business of the target company more effectively and, therefore, create additional shareholder value. This justification is often used for an unrelated diversification strategy.
2. Although most top-level managers are aware that the majority of acquisitions destroy rather than create shareholder value, they see themselves as the exceptions to the rule.

Managerial hubris has led to many ill-fated deals, destroying billions of dollars. For example, Quaker Oats Co. acquired Snapple because its managers thought Snapple was another Gatorade, which was a successful previous acquisition.⁶⁶ The difference was that Gatorade had been a standalone company and was easily integrated, but Snapple relied on a decentralized network of independent distributors and retailers who did not want Snapple to be taken over and who made it difficult and costly for Quaker Oats to integrate Snapple. The acquisition failed—and Quaker Oats itself was taken over by PepsiCo. Snapple was spun out and eventually ended up being part of the Dr Pepper Snapple Group.

THE DESIRE TO OVERCOME COMPETITIVE DISADVANTAGE. In some instances, mergers are not motivated by gaining competitive advantage, but by the attempt to overcome a competitive disadvantage. For example, to compete more successfully with Nike, the worldwide leader in sports shoes and apparel, Adidas (number two) acquired Reebok (number three) for \$3.8 billion in 2006. This acquisition allows the now-larger Adidas group to benefit from economies of scale and scope that were unachievable when Adidas and Reebok operated independently. The hope was that this would help in overcoming Adidas' competitive disadvantage vis-à-vis Nike. In the meantime, Under Armour has outperformed Adidas in the U.S. market and has become the number two after Nike.

SUPERIOR ACQUISITION AND INTEGRATION CAPABILITY. Acquisition and integration capabilities are not equally distributed across firms. Although there is strong evidence that mergers and acquisitions, *on average*, destroy rather than create shareholder value, it does not exclude the possibility that *some* firms are consistently able to identify, acquire, and

integrate target companies to strengthen their competitive positions. Since it is valuable, rare, and difficult to imitate, a superior acquisition and integration capability, together with past experience, can lead to competitive advantage.

Disney has shown superior post-merger integration capabilities after acquiring Pixar, Marvel, and Lucasfilm. Disney managed its new subsidiaries more like alliances rather than attempting full integration, which could have destroyed the unique value of the acquisitions. In Pixar's case, Disney kept the entire creative team in place and allowed its members to continue to work in Pixar's headquarters near San Francisco with minimal interference. The hands-off approach paid huge dividends: Although Disney paid a steep \$7.4 billion for Pixar, it made some \$10 billion on Pixar's *Toy Story 3* franchise revenues alone. As a consequence, Disney has gained a competitive advantage over its rivals such as Sony and has also outperformed the Dow Jones Industrial Average over the past few years by a wide margin.

9.4 Implications for Strategic Leaders

The business environment is constantly changing.⁶⁷ New opportunities come and go quickly. Firms often need to develop new resources, capabilities, or competencies to take advantage of opportunities. Examples abound. Traditional book publishers must transform themselves into digital content companies. Old-line banking institutions with expensive networks of branches must now offer seamless online banking services. They must make them work between a set of traditional and nontraditional payment services on a mobile platform. Energy providers are in the process of changing their coal-fired power plants to gas-fired ones in the wake of the shale gas boom. Pharmaceutical companies need to take advantage of advances in biotechnology to drive future growth. Food companies are now expected to offer organic, all natural, and gluten-free products.

The strategic leader also knows that firms need to grow to survive and prosper, especially if they are publicly traded stock companies. A firm's corporate strategy is critical in pursuing growth. To be able to grow as well as gain and sustain a competitive advantage, a firm must not only possess VRIO resources but also be able to leverage existing resources, often in conjunction with partners, and build new ones. The question of how to build new resources, capabilities, and competencies to grow your enterprise lies at the center of corporate strategy. Strategic alliances, mergers, and acquisitions are the key tools that the strategist uses in executing corporate strategy.

Ideally, the tools to execute corporate strategy—strategic alliances and acquisitions—should be centralized and managed at the corporate level, rather than at the level of the strategic business unit. This allows the company to not only assess their effect on the overall company performance, but also to harness spillovers between the different corporate development activities. That is, corporate-level managers should not only coordinate the firm's portfolio of alliances, but also leverage their relationships to successfully engage in mergers and acquisitions.⁶⁸ Rather than focusing on developing an alliance management capability in isolation, firms should develop a *relational capability* that allows for the successful management of both strategic alliances *and* mergers and acquisitions. In sum, to ensure a positive effect on competitive advantage, the management of strategic alliances and M&A needs to be placed at the corporate level.

We now have concluded our discussion of corporate strategy. Acquisitions and alliances are key vehicles to execute corporate strategy, each with its distinct advantages and disadvantages. It is also clear from this chapter that strategic alliances, as well as mergers and acquisitions, are a global phenomenon. In the next chapter, we discuss strategy in a global world.

CHAPTERCASE 9 / Consider This. . .

ONE OTHER STRATEGIC reason Lyft entered alliances with GM and Waymo is access to critical complementary assets.

Both Lyft and GM bring critical complementary assets to bear in this alliance. GM has upstream core competencies in manufacturing cost-competitive and reliable cars at a large scale. Lyft, in turn, has downstream competencies by owning the second-largest mobile transportation network globally, and with it the data that allow Lyft to develop proprietary algorithms to have cars at the right time and at the right price.

Alphabet's Waymo, moreover, was an early leader in autonomous vehicle development. Where Waymo lags Tesla in driverless car technology, however, is the fact that Tesla has racked up more than a billion miles driven by its vehicles themselves as Tesla owners use its innovative autopilot feature. Every time a Tesla driver engages the autopilot, Tesla accrues more miles and with it data, allowing it to update its software driving the cars and making its autopilot even better. Much like Google's Android mobile operating system for phones, Waymo provides the software that is the brains behind the self-driving car technology, but lacks an opportunity for large-scale deployment, which constrains testing and learning. The alliance with Lyft allows Waymo to deploy its self-driving car technology on a large scale. The goal is to

create a fleet of autonomous GM vehicles on Lyft's network, driving with Waymo's autopilot technology.

Questions

1. Describe the reasons Lyft entered strategic alliances with GM and Waymo? Are some reasons more important than others? Why or why not? Explain.
2. GM invested \$500 million in Lyft in 2016. What are some possible reasons GM entered an equity alliance with Lyft? Are there any reasons GM would prefer Lyft over Uber as an alliance partner?
3. What are some possible reasons Waymo entered an alliance with Lyft? Are there any reasons Waymo would prefer Lyft over Uber as an alliance partner?
4. In terms of valuations, Uber (with \$70 billion) is almost 10 times more valuable than Lyft (with \$7.5 billion). Uber is active in some 600 cities worldwide, while Lyft services some 200 (in the United States only). Uber offers about five times as many rides as Lyft. Uber is clearly a giant compared to Lyft. Do you think the strategic alliances with GM and Waymo could help Lyft to overcome Uber's lead? Can you think of other reasons Lyft could end up as the winner in the mobile transportation network competition? Explain.

TAKE-AWAY CONCEPTS

This chapter discussed two mechanisms of corporate-level strategy—alliances and acquisitions—as summarized by the following learning objectives and related take-away concepts.

LO 9-1 / Apply the build-borrow-or-buy framework to guide corporate strategy.

- The build-borrow-or-buy framework provides a conceptual model that aids strategists in deciding whether to pursue internal development (*build*), enter a contract arrangement or strategic alliance (*borrow*), or acquire new resources, capabilities, and competencies (*buy*).

- Firms that are able to learn how to select the right pathways to obtain new resources are more likely to gain and sustain a competitive advantage.

LO 9-2 / Define strategic alliances, and explain why they are important to implement corporate strategy and why firms enter into them.

- Strategic alliances have the goal of sharing knowledge, resources, and capabilities to develop processes, products, or services.
- An alliance qualifies as strategic if it has the potential to affect a firm's competitive advantage by increasing value and/or lowering costs.

- The most common reasons firms enter alliances are to (1) strengthen competitive position, (2) enter new markets, (3) hedge against uncertainty, (4) access critical complementary resources, and (5) learn new capabilities.

LO 9-3 / Describe three alliance governance mechanisms and evaluate their pros and cons.

- Alliances can be governed by the following mechanisms: contractual agreements for non-equity alliances, equity alliances, and joint ventures.
- There are pros and cons of each alliance governance mechanism, shown in detail in Exhibit 9.2 with highlights as follows:

Non-equity alliance's pros: flexible, fast, easy to get in and out; cons: weak ties, lack of trust/commitment.

Equity alliance's pros: stronger ties, potential for trust/commitment, window into new technology (option value); cons: less flexible, slower, can entail significant investment.

Joint venture pros: strongest tie, trust/commitment most likely, may be required by institutional setting; cons: potentially long negotiations and significant investments, long-term solution, managers may have two reporting lines (two bosses).

LO 9-4 / Describe the three phases of alliance management and explain how an alliance management capability can lead to a competitive advantage.

- An alliance management capability consists of a firm's ability to effectively manage alliance-related tasks through three phases: (1) partner selection and alliance formation, (2) alliance design and governance, and (3) post-formation alliance management.
- An alliance management capability can be a source of competitive advantage as better management of alliances leads to more likely superior performance.
- Firms build a superior alliance management capability through "learning by doing" and by establishing a dedicated alliance function.

LO 9-5 / Differentiate between mergers and acquisitions, and explain why firms would use either to execute corporate strategy.

- A merger describes the joining of two independent companies to form a combined entity.
- An acquisition describes the purchase or takeover of one company by another. It can be friendly or hostile.
- Although there is a distinction between mergers and acquisitions, many observers simply use the umbrella term *mergers and acquisitions*, or M&A.
- Firms can use M&A activity for competitive advantage when they possess a superior relational capability, which is often built on superior alliance management capability.

LO 9-6 / Define horizontal integration and evaluate the advantages and disadvantages of this option to execute corporate-level strategy.

- Horizontal integration is the process of merging with competitors, leading to industry consolidation.
- As a corporate strategy, firms use horizontal integration to (1) reduce competitive intensity, (2) lower costs, and (3) increase differentiation.

LO 9-7 / Explain why firms engage in acquisitions.

- Firms engage in acquisitions to (1) access new markets and distributions channels, (2) gain access to a new capability or competency, and (3) preempt rivals.

LO 9-8 / Evaluate whether mergers and acquisitions lead to competitive advantage.

- Most mergers and acquisitions destroy shareholder value because anticipated synergies never materialize.
- If there is any value creation in M&A, it generally accrues to the shareholders of the firm that is taken over (the acquiree), because acquirers often pay a premium when buying the target company.
- Mergers and acquisitions are a popular vehicle for corporate-level strategy implementation for three reasons: (1) because of principal-agent problems, (2) the desire to overcome competitive disadvantage, and (3) the quest for superior acquisition and integration capability.

KEY TERMS

Acquisition (<i>p. 323</i>)	Equity alliance (<i>p. 319</i>)	Non-equity alliance (<i>p. 318</i>)
Alliance management capability (<i>p. 320</i>)	Explicit knowledge (<i>p. 319</i>)	Real-options perspective (<i>p. 316</i>)
Build-borrow-or-buy framework (<i>p. 310</i>)	Horizontal integration (<i>p. 323</i>)	Relational view of competitive advantage (<i>p. 314</i>)
Co-opetition (<i>p. 316</i>)	Hostile takeover (<i>p. 323</i>)	Strategic alliances (<i>p. 313</i>)
Corporate venture capital (CVC) (<i>p. 319</i>)	Learning races (<i>p. 316</i>)	Tacit knowledge (<i>p. 319</i>)
	Managerial hubris (<i>p. 328</i>)	
	Merger (<i>p. 323</i>)	

DISCUSSION QUESTIONS

1. The chapter identifies three governing mechanisms for strategic alliances: non-equity, equity, and joint venture. List the benefits and downsides for each of these mechanisms.
2. An alliance's purpose can affect which governance structure is optimal. Compare a pharmaceutical R&D alliance with a prescription-drug marketing agreement, and recommend a governing mechanism for each. Provide reasons for your selections.
3. Alliances are often used to pursue business-level goals, but they may be managed at the corporate level. Explain why this portfolio approach to alliance management would make sense.

ETHICAL/SOCIAL ISSUES

1. If mergers and acquisitions quite often end up providing a competitive disadvantage, why do so many of them take place? Given the poor track record, is the continuing M&A activity a result of principal-agent problems and managerial hubris? What can be done to overcome principal-agent problems? Are there other reasons for poor performance?
2. In this chapter three main reasons are given for why one firm would acquire another. In July 2016 Verizon announced it was going to acquire Yahoo for \$4.8 billion in cash. The announcement discussed Verizon's earlier purchase of AOL and noted Yahoo would speed up the digital advertising business. Verizon noted Yahoo has over 1 billion users globally and several premium brands in finance, news, and sports. Based on Verizon's information, which of the three acquisition reasons seems most prevalent?
 In the fall of 2016 Yahoo disclosed several major security breaches involving more than 1.5 billion user accounts. The results of these disclosures delayed the purchase by Verizon and reduced the Yahoo purchase price by at least \$300 million. In June 2017 Yahoo shareholders agreed to the final sale to Verizon, nearly a year after the purchase was announced. What responsibility do firms have for the protection of customer data provided in the operation of their firm? Should Verizon have backed out of the deal with Yahoo given the scale and duration of the security issues brought to light in the fall of 2016?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

In this chapter, we studied horizontal integration and the build-borrow-or-buy framework. One industry currently consolidating is furniture manufacturing, with thousands of manufacturers and suppliers. Manufacturers range from large recognizable brands, such as Baker, Steelcase, and La-Z-Boy, to small family-owned companies. Demand for both office furniture and residential furniture is experiencing postrecession growth. Analysts have observed that companies are shopping for acquisitions as consumers are shopping for furniture.

Charter Capital Partners in Grand Rapids, Michigan, is a mergers and acquisitions adviser helping companies initiate, negotiate, and close deals on one company's purchase of another. To take advantage of the increase in M&A activity in the furniture manufacturing industry, Charter recently launched a dedicated furniture practice. Western Michigan is home to the top three office furniture manufacturers, which is a key segment of the industry. The sales of the top three make up half of the industry's \$10 billion market.

Charter Capital Partners has hired your small consulting team to do the basic research regarding a client that has recently approached the group. The client is a small manufacturer of office furniture in a medium-sized town in Michigan. The managers are seeking advice as they decide whether to upgrade capabilities in order to expand sales, to find a partner with complementary skills, or to sell to a larger company. The owner has stated that the firm is like a family, and he feels a sense of loyalty to the workers and the community. The firm has had steady sales over its history,

although it experienced a slight dip in sales during the recession. The company is aware that other office furniture manufacturers are beginning to integrate technology into the furniture. For example, one competitor is building wireless technology into desk surfaces to power several devices at one time and avoid the need to plug them in. The owner sees the integration of technology as a game changer.

Using the build-borrow-or-buy framework and other strategic concepts, develop a set of questions to ask the managers of this small business to help you gather information regarding whether to hire new employees with more sophisticated technology expertise in order to build capabilities *in-house* or whether to *partner* with another firm that already has these capabilities. Alternatively, consider information that could help the owner decide whether this is the time to sell to a larger company. Your consulting team will need adequate information to help put a value on the firm in order to advise Charter if/when it initiates a search for a partner or buyer.

//// Small Group Exercise 2

In Strategy Highlight 9.2 Kraft is shown to be prone to using hostile takeovers. These acquisitions are completed over the objections of the acquired firm. As noted in the text, mergers and acquisitions sometimes have difficulty creating enhanced competitive advantage. In your group discuss what additional burdens a hostile takeover must overcome to generate positive advantages for the acquiring company. How is a hostile takeover more difficult than a cooperative merger or acquisition?

mySTRATEGY

What Is Your Network Strategy for Your Career?

Most of us participate in one or more popular social networks online such as Facebook, LinkedIn, Pinterest, Snapchat, or Twitter. While many of us spend countless hours in these social networks, you may not have given a lot of thought to your network strategy.

Social networks describe the relationships or ties between individuals linked to one another. An important element of social networks is the *different strengths of ties* between individuals. Some ties between two people in a network may be very strong (e.g., soul mates or best friends), while others are weak (mere acquaintances—"I talk to her briefly in the cafeteria at work"). As a member of a social network, you have access to *social capital*, which is derived from the connections within and between social networks. It is a function of whom you know,

and what advantages you can create through those connections. Social capital is an important concept in business. Remember the old adage: *What matters is not what you know, but whom you know.*

Some Facebook users claim to have 2,000 or more “friends.” With larger networks, one expects to have greater social capital, right? Though this seems obvious, academic research suggests that humans have the brain capacity to maintain a functional network of only about 150 people. This so-called *Dunbar number* was derived by extrapolating from the brain sizes and social networks of primates.

Far-fetched? Not necessarily. You may have a lot more than 150 friends on Facebook or connections on LinkedIn, but researchers call that number the *social core* of any network. Why is this the case? Even though it takes only a split second to accept a new request on Facebook or LinkedIn, relationships still need to be groomed. To develop a meaningful relationship, you need to spend some time with this new connection, even in cyberspace.

Social networking sites allow users to broadcast their lives and to passively keep track of more people. They enlarge their social networks, even though many of those ties tend to be weak. It may come as a surprise, however, to learn that research

shows new opportunities such as job offers tend to come from weak ties, because it is these weak ties that allow you to access nonredundant and novel information. This phenomenon is called *strength of weak ties*. So, in thinking about how to leverage your social capital more fully as part of your career network strategy, rather than always communicating with the same people, it may pay for you to invest a bit more time in grooming your weak ties.⁶⁹

1. Create a list of up to 12 people at your university (or work environment if applicable) with whom you regularly communicate (in person, electronically, or both). Draw your network (place names or initials next to each node), and connect every node where people you communicate with also talk to one another (i.e., indicate friends of friends). Can you identify strong and weak ties in your network?
2. Now compare your actual career-related network using a site such as LinkedIn. Are any of your connections linked together? With how many alumni from your university are you linked? These alumni can provide a source of weak ties that may help you get a foot in the door at a potential new employer if you leverage them effectively.

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CHAPTER 10 Global Strategy: Competing Around the World

Chapter Outline

- 10.1 What Is Globalization?**
Stages of Globalization
State of Globalization
- 10.2 Going Global: Why?**
Advantages of Going Global
Disadvantages of Going Global
- 10.3 Going Global: Where and How?**
Where in the World to Compete? The CAGE Distance Framework
How Do MNEs Enter Foreign Markets?
- 10.4 Cost Reductions vs. Local Responsiveness: The Integration-Responsiveness Framework**
International Strategy
Multidomestic Strategy
Global-Standardization Strategy
Transnational Strategy
- 10.5 National Competitive Advantage: World Leadership in Specific Industries**
Porter's Diamond Framework
- 10.6 Implications for Strategic Leaders**

Learning Objectives

- LO 10-1** Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.
- LO 10-2** Explain why companies compete abroad, and evaluate the advantages and disadvantages of going global.
- LO 10-3** Apply the CAGE distance framework to guide MNE decisions on which countries to enter.
- LO 10-4** Compare and contrast the different options MNEs have to enter foreign markets.
- LO 10-5** Apply the integration-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.
- LO 10-6** Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

Sweden's IKEA: The World's Most Profitable Retailer

THE WORLD'S MOST profitable global retailer is not Walmart or the UK-based Tesco, but IKEA—a privately owned home-furnishings company hailing from Sweden. In 2017, IKEA owned more than 400 stores in various formats worldwide in 28 countries, employed over 160,000 people, and earned revenues of more than 35 billion euros. Exhibit 10.1 shows IKEA's growth in the number of stores and revenues worldwide.

Known today for its iconic blue-and-yellow big-box retail stores, focusing on flat-pack furniture boxes combined with a large do-it-yourself component, IKEA started as a small retail outlet in 1943 by then-17-year-old Ingvar Kamprad. Though IKEA has become a global phenomenon, it was initially slow to internationalize. It took 20 years before the company expanded beyond Sweden to its neighbor Norway. After honing and refining its core competencies—designing and offering modern, and

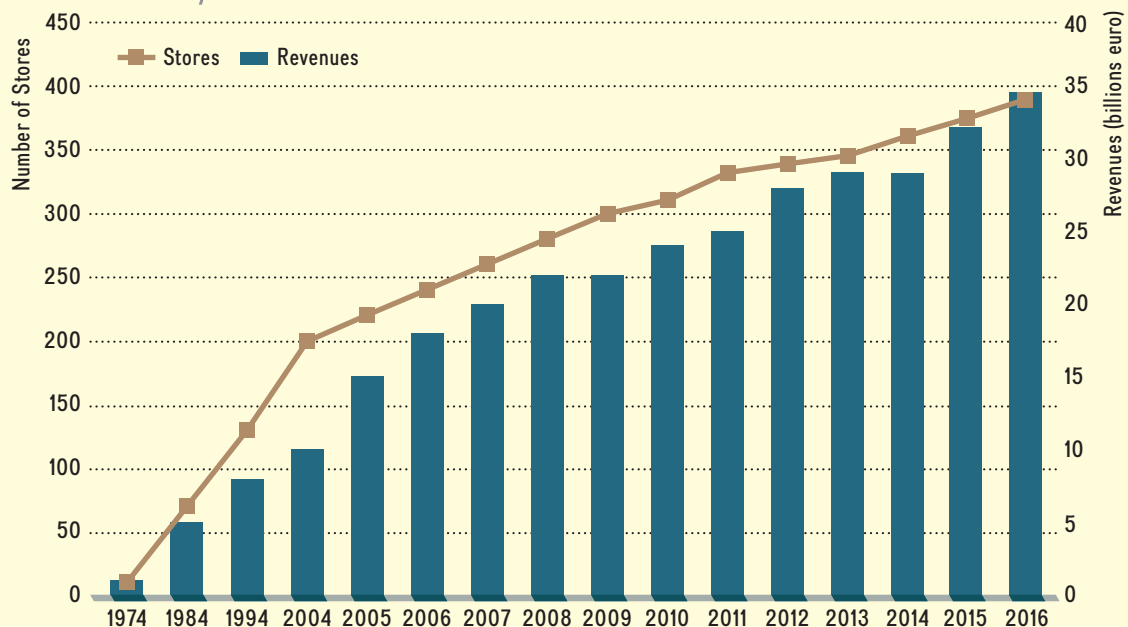


Sweden's IKEA is growing quickly in both developed countries, such as the United States and Australia, and also in emerging economies such as China.

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functional home furnishings in a unique retail experience resulting in a low cost structure—in its home market, IKEA followed an international strategy, expanding first to Europe and then beyond. Under this strategy, IKEA can

EXHIBIT 10.1 / IKEA Stores and Revenues, 1974–2016



SOURCE: Depiction of data from IKEA Yearly Summaries (www.ikea.com), various years.

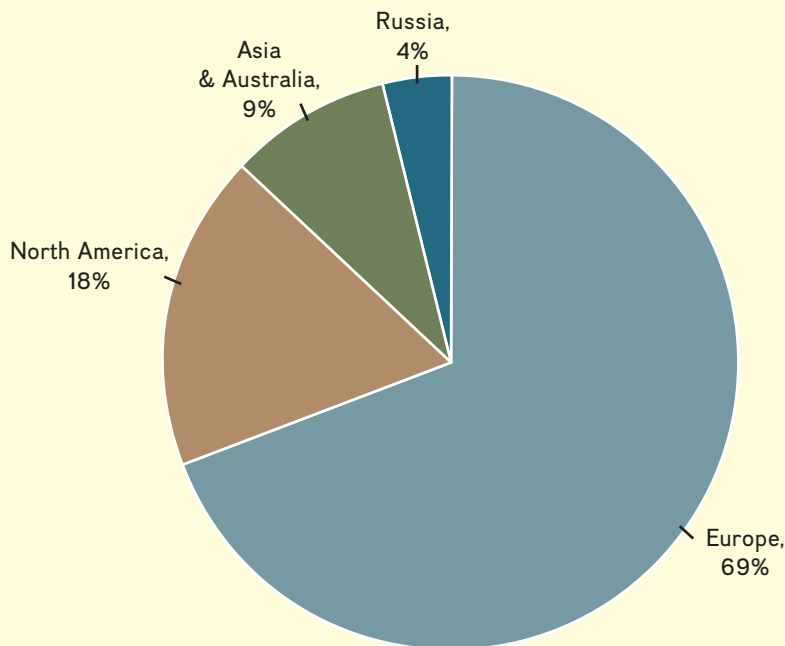
sell the same types of home furnishings across the globe with little adaptation, although it does make some allowances for country preferences. IKEA is present across all major markets today, having entered India and Serbia in 2017.

In recent years IKEA's strategy has evolved. To keep costs low, it shifted from an international strategy to a global-standardization strategy, in which it attempts to achieve economies of scale through effectively managing a global supply chain. Although Asia accounts currently for only 9 percent of its sales, IKEA sources 35 percent of its inputs from this region. To pare costs further, IKEA has begun to implement production techniques from auto and electronics industries, using cutting-edge technologies to address complexity while achieving flexibility and low cost. IKEA's revenues by geographic region are mainly from Europe (69 percent), with the rest from North America (18 percent), Asia and Australia (9 percent), and Russia (4 percent); see Exhibit 10.2. Although IKEA's largest market is in Germany (14 percent of total sales), it is seeing strong growth in China, Canada, Poland, and Australia.

The privately held company has also successfully reinvented itself with changing consumer demands: newer formats such as smaller stores in city centers, click-and-collect locations (small stores for retrieval of online purchases), and more customized furniture solutions to meet the needs of an increasingly urban population. In addition, IKEA is investing heavily in its online presence, enabling consumers to do all their purchasing online, and then schedule delivery, and even installation of furniture. Busy urban professionals are less inclined to spend the well-known frustrating and long hours putting IKEA furniture together ("easy assembly") with the included low-quality tool and minimal instructions. IKEA's functional website (ikea.com) now garners more than 2 billion hits a year. In the meantime, IKEA's big-box stores remain attractive destinations, with over 1 billion visits a year, up from some 750 million just a few years earlier.¹

You will learn more about IKEA by reading this chapter; related questions appear in "ChapterCase 10 / Consider This...."

EXHIBIT 10.2 / IKEA Sales by Geographic Region (2016)



SOURCE: Depiction of data from IKEA Yearly Summaries (www.ikea.com)

 **IT IS SOMEWHAT** surprising that a privately held furniture maker from Sweden is the world's most profitable retailer and not a behemoth such as the U.S.-based Walmart or the United Kingdom's Tesco. IKEA's success in its international markets is critical to its competitive advantage. IKEA succeeds in both rich developed countries such as the United States and Germany, as well as in emerging economies such as China, India, and Russia. Hailing from a small country in Europe, IKEA earns the vast majority of its revenues outside of its borders. Moreover, IKEA's fastest growth is outside Europe.

IKEA intends to reach sales of 50 billion euros by 2020, up from 35 billion euros in 2016, and double its 2011 sales of 25 billion euros. It wants to own 500 profitable stores globally by 2020, up from some 240 stores in 2006. To accomplish these lofty goals, IKEA must get its global strategy right, especially in growing markets such as China and India. Both are countries with more than 1 billion people each and a rapidly expanding middle class, on which IKEA wants to capitalize.

For more and more U.S. companies, international markets offer the biggest growth opportunities, just as they do for IKEA. Firms from a wide variety of industries—such as Apple, Caterpillar, GE, Intel, and IBM—are global enterprises. They have a global work force and manage global supply chains, and they obtain the majority of their revenues from outside their home market. Once-unassailable U.S. firms now encounter formidable foreign competitors such as Brazil's Embraer (aerospace); China's Alibaba (ecommerce), Haier (home appliances), Lenovo (PCs), and Huawei (cell phones); India's ArcelorMittal (steel), Infosys (IT services), and Reliance Group (conglomerate); Germany's Siemens (engineering conglomerate), Daimler, BMW, and VW (vehicles); Japan's Toyota, Honda, and Nissan (vehicles); Mexico's Cemex (cement); Russia's Gazprom (energy); South Korea's LG and Samsung (both in electronics and appliances); and Sweden's IKEA (home furnishings), to name just a few. This chapter is about how firms gain and sustain competitive advantage when competing around the world.

The competitive playing field is becoming increasingly global, as the ChapterCase about the home-furnishings industry indicates. This globalization provides significant opportunities for individuals, companies, and countries. Indeed, you can probably see the increase in globalization on your own campus. The number of students enrolled at universities outside their native countries quadrupled between 1980 and 2014 to over 4 million.² By 2025, the total number is predicted to double yet again, to 8 million.³ The country of choice for foreign students remains the United States, with more than 1 million international students enrolled per year, followed by the United Kingdom. The top five countries sending the most students to study abroad are (in rank order): China, India, Korea, Germany, and Saudi Arabia.⁴

In Chapter 8, we looked at the first two dimensions of corporate strategy: managing the degree of vertical integration, and deciding which products and services to offer (the degree of diversification). Now we turn to the third dimension: competing effectively around the world. The world's marketplace—made up of some 200 countries—is a staggering \$76 trillion in gross domestic product (GDP), of which the U.S. market is roughly \$18 trillion, or about 24 percent.⁵

We begin this chapter by defining globalization and presenting stages of globalization. We then tackle a number of questions that a firm must answer: Why should a company go global? Where and how should it compete? We present the CAGE⁶ distance model to answer the question of where the firm should compete globally and the integration-responsiveness framework to link a firm's options of how to compete globally with the different business strategies introduced in Chapter 6 (cost leadership, differentiation, and blue ocean). We then debate the question of why world leadership in specific industries is often concentrated in certain geographic areas. We conclude with the practical *Implications for Strategic Leaders*.

LO 10-1

Define globalization, multinational enterprise (MNE), foreign direct investment (FDI), and global strategy.

Globalization The process of closer integration and exchange between different countries and peoples worldwide, made possible by falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.

multinational enterprise (MNE) A company that deploys resources and capabilities in the procurement, production, and distribution of goods and services in at least two countries.

global strategy Part of a firm's corporate strategy to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.

foreign direct investment (FDI) A firm's investments in value chain activities abroad.

10.1 What Is Globalization?

Globalization is a process of closer integration and exchange between different countries and peoples worldwide, made possible by falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.⁷ Combined, these factors reduce the costs of doing business around the world, opening the doors to a much larger market than any one home country. Globalization also allows companies to source supplies at lower costs, to learn new competencies, and to further differentiate products. Consequently, the world's market economies are becoming more integrated and interdependent.

Globalization has led to significant increases in living standards in many economies around the world. Germany and Japan, countries that were basically destroyed after World War II, turned into industrial powerhouses, fueled by export-led growth. The Asian Tigers—Hong Kong, Singapore, South Korea, and Taiwan—turned themselves from underdeveloped countries into advanced economies, enjoying some of the world's highest standards of living. China and India continue to offer significant business opportunities.⁸ Indeed, China, with \$11 trillion in GDP, has become the second-largest economy worldwide after the United States (with \$18 trillion in GDP) and ahead of Japan in third place (\$5 trillion GDP), in absolute terms.⁹ Adjusting GDP for size of population (per capita) and adjusting for difference in cost of living (purchasing power parity), the United States is in 12th place, China comes in at 92nd, and Japan ranks 27th. The three richest countries in the world by income per person are Qatar, Macao (which is a Special Administrative Region of China), and Kuwait; all of which are smaller but wealthy countries.

The engine behind globalization is the **multinational enterprise (MNE)**—a company that deploys resources and capabilities in the procurement, production, and distribution of goods and services in at least two countries. MNEs need an effective **global strategy** that enables them to gain and sustain a competitive advantage when competing against other foreign and domestic companies around the world.¹⁰ By making investments in value chain activities abroad, MNEs engage in **foreign direct investment (FDI)**.¹¹

For example, the European aircraft maker Airbus invested \$600 million in Mobile, Alabama, to build jetliners.¹² The new Mobile Aeroplex is a 53-acre facility where Airbus builds the vast majority of its single-aisle A-320 jetliners. Airbus made a significant strategic commitment to the U.S. market, the destination of the majority of its new jetliners; the A-320 is mainly used in domestic U.S. air travel. Being located in Alabama allows Airbus to be much closer to its customers and thus to receive and incorporate feedback, as individual airlines request specific customizations. It allows Airbus to take advantage of business-friendly conditions such as lower taxes, labor cost, and cost of living, plus other incentives provided by host states in the Southern United States. Making Airbus planes in the United States also prevents the European company from being forced to accept import restrictions.

U.S. MNEs have a disproportionately positive impact on the U.S. economy.¹³ Well-known U.S. multinational enterprises include Boeing, Caterpillar, Coca-Cola, GE, John Deere, Exxon Mobil, IBM, P&G, and Walmart. U.S. MNEs make up less than 1 percent of the number of total U.S. companies, but they:

- Account for 11 percent of private-sector employment growth since 1990.
- Employ 19 percent of the work force.
- Pay 25 percent of the wages.
- Provide for 31 percent of the U.S. gross domestic product (GDP).
- Make up 74 percent of private-sector R&D spending.

As a business student, you have several reasons to be interested in MNEs. Not only can these companies provide interesting work assignments in different locations throughout

the world, but they also frequently offer the highest-paying jobs for college graduates. Even if you don't want to work for an MNE, chances are that the organization you will be working for will do business with one, so it's important to understand how they compete around the globe.

STAGES OF GLOBALIZATION

Since the beginning of the 20th century, globalization has proceeded through three notable stages.¹⁴ Each stage presents a different global strategy pursued by MNEs headquartered in the United States.

GLOBALIZATION 1.0: 1900–1941. Globalization 1.0 took place from about 1900 through the early years of World War II. In that period, basically all the important business functions were located in the home country. Typically, only sales and distribution operations took place overseas—essentially exporting goods to other markets. In some instances, firms procured raw materials from overseas. Strategy formulation and implementation, as well as knowledge flows, followed a one-way path—from domestic headquarters to international outposts. This time period saw the blossoming of the idea of MNEs. It ended with the U.S. entry into World War II.

GLOBALIZATION 2.0: 1945–2000. With the end of World War II came a new focus on growing business—not only to meet the needs that went unfulfilled during the war years but also to reconstruct the damage from the war. From 1945 to the end of the 20th century, in the Globalization 2.0 stage, MNEs began to create smaller, self-contained copies of themselves, with all business functions intact, in a few key countries; notably, Western European countries, Japan, and Australia.

This strategy required significant amounts of foreign direct investment. Although it was costly to duplicate business functions in overseas outposts, doing so allowed for greater local responsiveness to country-specific circumstances. While the U.S. corporate headquarters set overarching strategic goals and allocated resources through the capital budgeting process, local mini-MNE replicas had considerable leeway in day-to-day operations. Knowledge flow back to U.S. headquarters, however, remained limited in most instances.

GLOBALIZATION 3.0: 21ST CENTURY. Since 2001, we are in the Globalization 3.0 stage. One watershed event was China's entry into the World Trade Organization in the same year. The World Trade Organization (WTO) is a global organization overseeing and administering the rules of trade between nations.¹⁵ The goal of the WTO is to help companies conduct their business across borders based on multinational treaties that are negotiated and signed by its 164 member nations.

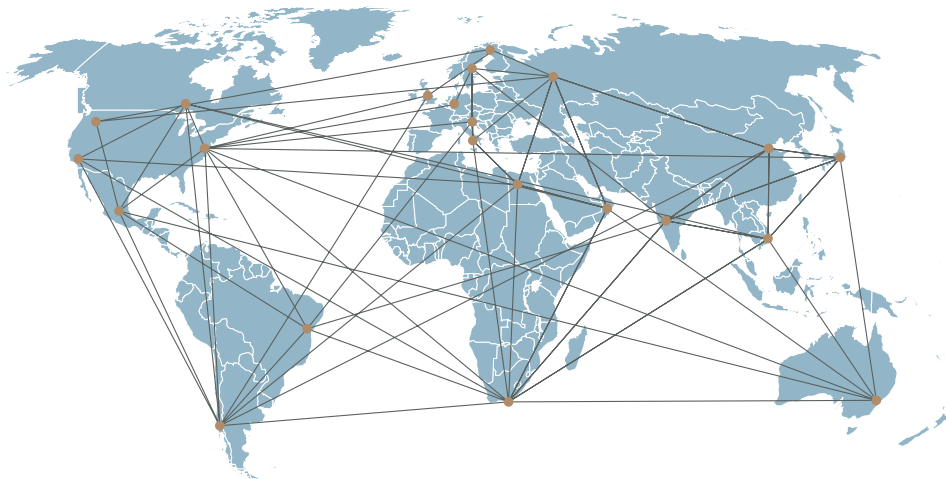
MNEs that had been the vanguard of globalization have since become global collaboration networks (see Exhibit 10.3). Such companies now freely locate business functions anywhere in the world based on an optimal mix of costs, capabilities, and PESTEL factors. Huge investments in fiber-optic cable networks around the world have effectively reduced communication distances, enabling companies to operate 24/7, 365 days a year. When an engineer in Minneapolis, Minnesota, leaves for the evening, an engineer in Mumbai, India, begins her workday. In the Globalization 3.0 stage, the MNE's strategic objective changes. The MNE reorganizes from a multinational company with self-contained operations in a few selected countries to a more seamless global enterprise with centers of expertise. Each of these centers of expertise is a hub within a global network for delivering products and services. Consulting companies, for example, can now tap into a worldwide network of experts in real time, rather than relying on the limited number of employees in their local offices.

EXHIBIT 10.3

Globalization 3.0: 21st Century

Based on an optimal mix of costs, skills, and PESTEL factors, MNEs are organized as global collaboration networks that perform business functions throughout the world.

SOURCE: Adapted from “A Decade of Generating Higher Value at IBM,” www.ibm.com, 2009.



Creating a global network of local expertise is beneficial not only in service industries, but also in the industrial sector. To increase the rate of low-cost innovation that can then be used to disrupt existing markets, GE organizes local growth teams in China, India, Kenya, and many other emerging countries.¹⁶ GE uses the slogan “in country, for country” to describe the local growth teams’ autonomy in deciding which products and services to develop, how to make them, and how to shape the business model. Many of these low-cost innovations, first developed to serve local needs, are later introduced in Western markets to become disruptive innovations. Examples include the Vscan, a handheld ultrasound device developed in China; the MAC 400, an ECG device developed in India (details follow later); and the 9100c, an anesthesia system developed in Kenya.¹⁷

Some new ventures organize as global collaboration networks from the start. Logitech, the maker of wireless peripherals such as computer mice, presentation “clickers,” and video game controllers, started in Switzerland but quickly established offices in Silicon Valley, California.¹⁸ Pursuing a global strategy right from the start allowed Logitech to tap into the innovation expertise contained in Silicon Valley.¹⁹ In 2016, Logitech had sales of over \$2 billion, with offices throughout the Americas, Asia, and Europe. Underlying Logitech’s innovation competence is a network of best-in-class skills around the globe. Based on its geographic presence, Logitech can organize work continuously because its teams in different locations around the globe can work 24/7.

Indeed, the trend toward global collaboration networks during the Globalization 3.0 stage raises the interesting question, “What defines a U.S. company?” If it’s the address of the headquarters, then IBM, GE, and others are U.S. companies—despite the fact that a majority of their employees work outside the United States. In many instances, the majority of their revenues also come from outside the United States. On the other hand, non-U.S. companies such as carmakers from Japan (Toyota, Honda, and Nissan) and South Korea (Hyundai and Kia) and several engineering companies (Siemens from Germany, and ABB, a Swiss-Swedish MNE) all have made significant investments in the United States and created a large number of well-paying jobs.

STATE OF GLOBALIZATION

Before we delve deeper into the question of why and how firms compete for advantage globally, a cautionary note concerning *globalization* is in order. Although many large firms are more than 50 percent globalized—meaning that more than half of their revenues are from outside the home country—the world itself is far less global.²⁰ If we look at a number

of different indicators, the level of globalization is no more than 10 to 25 percent. For example, only

- 2 percent of all voice-calling minutes are cross-border.²¹
- 3 percent of the world's population are first-generation immigrants.
- 9 percent of all investments in the economy are foreign direct investments.
- 15 percent of patents list at least one foreign inventor.
- 18 percent of internet traffic crosses national borders.

These data indicate that the world is not quite flat yet,²² or fully globalized, but at best *semi-globalized*. Pankaj Ghemawat reasons that many more gains in social welfare and living standards can be had through further globalization if future integration is managed effectively through coordinated efforts by governments.²³

The European Union is an example of coordinated economic and political integration by 28 countries (reduced to 27 after Brexit negotiations are finalized, expected in 2019), of which 19 use the euro as a common currency. This coordinated integration took place over several decades following World War II, precisely to prevent future wars in Europe. The EU encompasses 500 million people, which makes it one of the largest economic zones in the world. Indeed its GDP is a little bit larger than the United States, the largest single-country market in the world. Although the EU has monetary authority administered through the European Central Bank, it does not have fiscal (i.e., budgetary) authority. This important responsibility remains with national governments. This separation between monetary and fiscal authority allowed the sovereign debt crisis during 2009–2015 to emerge.

Continued economic development across the globe has two consequences for MNEs. First, rising wages and other costs are likely to negate any benefits of access to low-cost input factors. Second, as the standard of living rises in emerging economies, MNEs are hoping that increased purchasing power will enable workers to purchase the products they used to make for export only.²⁴ China's labor costs, for example, are steadily rising in tandem with an improved standard of living, especially in the coastal regions, where wages have risen 50 percent since 2005.

Some MNEs have boosted wages an extra 30 percent following labor unrest in recent years. Many now offer bonuses to blue-collar workers and are taking other measures to avoid sweatshop allegations that have plagued companies such as Nike, Apple, and Levi Strauss. Rising wages, fewer workers due to the effects of China's one-child-per-family policy, and appreciation of the Chinese currency now combine to lessen the country's advantage in low-cost manufacturing.²⁵ This shift is in alignment with the Chinese government's economic policy, which wants to see a move from "Made in China" to "Designed in China," to capture more of the value added.²⁶ For instance, the value added of manufacturing an iPhone by Foxconn in China is only about 5 percent.²⁷

GLOBALIZATION 3.1: RETRENCHMENT? Several *black swan events* (that is, highly improbable, but high-impact events) have buffeted the world economy in recent years. The global financial crisis between 2008 and 2010 led to a deep recession and high unemployment in many parts of the world, including the United States. At the same time, the European sovereign debt crisis unfolded with several countries teetering on the verge of insolvency, leading to high unemployment in some countries. For instance, about 50 percent of the people under 25 were unemployed in Spain and Greece. In the 2010s, the European refugee crisis unfolded with millions of people being displaced. Fleeing civil war zones as well as territory occupied by the Islamic State, over 1.3 million refugees in 2015 alone streamed into the European Union. While the crises in the United States and the EU unfolded, China continued to rise both in economic and political power, establishing itself as a superpower

to be reckoned with, potentially challenging the supremacy of the United States. Other countries, such as Russia and Turkey, appear to become more autocratic as time unfolds.

All of these macro events contributed to a rise of nationalism in the United States and Western Europe. In 2016, the British voted to leave the European Union. Right-wing parties registered strong gains in national elections in many European countries. Meanwhile, in the United States, during his inaugural speech in 2017, President Donald Trump proclaimed an “America first” policy.

As a consequence, globalization is currently undergoing some retrenchment with a stronger focus on nationalism. Rather than multinational trade deals negotiated by international bodies such as the WTO, bilateral treaties between countries are in vogue. The future viability of entire economic trading blocs such as the European Union or NAFTA are being questioned. Any resulting changes would likely affect cross-border trade in a negative fashion, impacting MNEs the most. It remains to be seen whether such sentiments will have lasting consequences over the next few years as this process of potential globalization retrenchment unfolds.

10.2 Going Global: Why?

LO 10-2

Explain why companies compete abroad, and evaluate the advantages and disadvantages of going global.

The decision to pursue international expansion results from the firm’s assessment that doing so enhances its competitive advantage and that the benefits of globalization exceed the costs. Simply put, firms expand beyond their domestic borders if they can increase their economic value creation ($V - C$) and enhance competitive advantage. As detailed in Chapter 5, firms enlarge their competitive advantage by increasing a consumer’s willingness to pay through higher perceived value based on differentiation and/or lower production and service delivery costs. Expanding beyond the home market, therefore, should reinforce a company’s basis of competitive advantage—whether differentiation, low-cost, or value innovation. Here we consider both the advantages and disadvantages of expanding beyond the home market (see Exhibit 10.4).

ADVANTAGES OF GOING GLOBAL

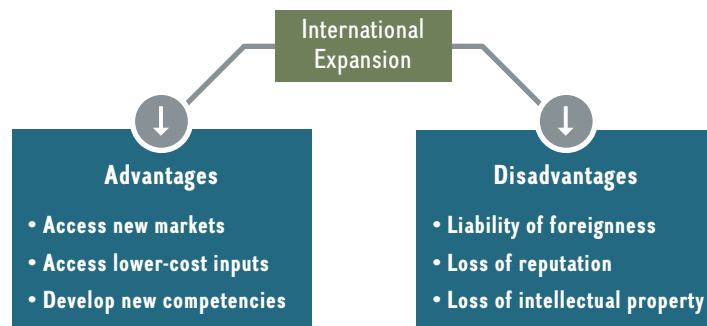
Why do firms expand internationally? The main reasons firms expand abroad are to

- Gain access to a larger market.
- Gain access to low-cost input factors.
- Develop new competencies.

GAIN ACCESS TO A LARGER MARKET. Becoming an MNE provides significant opportunities for companies, given *economies of scale* and *scope* that can be reaped by participating

EXHIBIT 10.4

Advantages and Disadvantages of International Expansion



Strategy Highlight 10.1

The Gulf Airlines Are Landing in the United States

Fasten your seat belts, Delta, American, and United. Severe turbulence may be ahead.

New entrants into both the domestic and international routes are increasing the competitive pressure on U.S. legacy air carriers. Three airlines—Emirates, Etihad Airways, and Qatar Airways—all from the Persian Gulf, are using a blue ocean strategy to attract new customers. The Gulf carriers offer higher quality at lower cost to break into international routes, the last remaining profit sanctuary of U.S. carriers. The legacy carriers have long been squeezed domestically by low-cost competitors such as Southwest, Frontier, Spirit, and others (see Strategy Highlight 3.2). Although most of the future growth is in Asia, the United States remains the world's largest air traffic market, still holding on to one-third of all business.

But look at the latest U.S. competitors. The Gulf carriers make flying enjoyable again, getting away from the Greyhound bus feel adopted by U.S. carriers to drive down costs. At many U.S. airlines, service has deteriorated as air travel has become a commodity, and price has become the main competitive weapon. A high-profile incident in 2017, as an already seated United Airlines passenger was removed by force to make room for late-arriving crew members hitching a ride, epitomized the service crisis in U.S. air travel. Caught on video by smartphones, the incident went viral, receiving global attention. Qatar Airways, one of the Gulf carriers, was quick to update its smartphone app to say that it “doesn't support drag and drop of passengers.”

The Gulf airlines bring back some of the service and glamour that used to be associated with air travel. They offer amenities such as higher-quality complimentary meals and hot towels in economy, in addition, to an open bar in business class, and private suites with showers in first class. Their ratio of flight attendants to passengers is also greater, including offering flying nannies to keep kids occupied, happy, and most importantly not crying. In their home base, they build airports reminiscent of luxury hotels with swimming pools above the concourse for laps during layovers, high-speed Wi-Fi, high-end conference rooms with the latest audiovisual equipment, plush lounges, and many other amenities.

Given their location on the Persian peninsula, the Gulf airlines

offer direct flights to major hubs in Europe, Asia, and the United States, using the newest and most modern aircraft. Their reach via direct flights extends to about 80 percent of the world's population. In particular, the Gulf carriers are already connecting Europe and Asia, having taken away major business from European airlines such as Lufthansa of Germany and British Airways. These so-called super-connectors already dominate the long-distance



An Emirates A-380 superjumbo jet takes off en route to the United States, flying past the famous Burj Al Arab hotel in Dubai, United Arab Emirates.

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route between Europe and Asia, growing its passengers threefold over the past decade. Moreover, traditional international airport hubs such as London, Frankfurt, and Amsterdam all have lost a large share of their business to the new luxury hubs in Dubai, Abu Dhabi, and Doha. The Gulf carriers are now attempting to repeat this feat in the United States, offering direct flights to many U.S. cities including Atlanta, Boston, Chicago, Dallas, Houston, Los Angeles, Miami, New York, Philadelphia, San Francisco, Seattle, Orlando, and Washington, D.C.

(continued)

U.S. carriers have complained that the Persian Gulf airlines receive unfair subsidies. CEOs of U.S. carriers have turned to politicians in Washington to stem the onslaught of the Gulf carriers. Customers, however, are voting with their wallets by flocking to the Gulf carriers, enjoying competitive prices and a better service experience. Moreover, the Gulf carriers counter that U.S. airlines have long enjoyed tightly regulated markets, restricting foreign competition. Moreover, they also remind the public that each of the U.S. legacy carriers has used bankruptcy filings to obtain debt relief, and that some legacy carriers received government bailouts. They suggest that the investments made by the government owners of the Persian Gulf carriers are merely equity investments as done by other stockholders.

Yet even the Gulf carriers are experiencing headwinds lately. Given the 50 percent decline in oil prices since 2014, other international airlines have become more cost-competitive. In addition, economic performance in the Gulf region is tightly linked to the price of oil. With falling oil prices, the spending power of companies in the region drops, and with it demand for business travel, the most profitable segment for airlines. A series of terrorist attacks at airports in the Middle East as well as the downing of a Russian passenger jet by a bomb in

the region have contributed to a sharp decline in air travel to and from the Middle East, including to the super-connector hubs. Finally, restrictions imposed by the American government on airlines flying from the region directly into the United States, such as a laptop ban on board, have redirected demand for air travel to European carriers, departing from Frankfurt, Amsterdam, London, or Paris.

One thing seems clear, however; the competitive pressure by the Gulf carriers on U.S. legacy carriers is likely to get stronger. The Persian Gulf states have decided that international air travel is a strategic future industry for the region. To back up their intent, the carriers made strong strategic commitments, not only by building the most modern and luxurious airports in the world, but also by locking up about half of the airframe makers' future production capacity. In particular, they ordered new super-modern, long-range airplanes made by Boeing (such as the new 787 Dreamliner) and Airbus (such as the A-380, the superjumbo). The Gulf carriers are already the fastest-growing airlines globally, yet they continue to push into larger markets and more attractive routes. In the meantime, consumers enjoy the benefits of globalization: more choice, more routes, better service and amenities, as well as lower prices.²⁸

in a much larger market. Companies that base their competitive advantage on *economies of scale* and *economies of scope* have an incentive to gain access to larger markets because this can reinforce the basis of their competitive advantage. This in turn allows MNEs to out-compete local rivals. In Strategy Highlight 6.1, we detailed how Narayana Health, a specialty hospital chain in India, founded and led by Dr. Devi Shetty, obtained a low-cost competitive advantage in complex procedures such as open-heart surgery. Narayana Health is now leveraging its low-cost, high-quality position by opening specialty hospitals in the Cayman Islands (to serve U.S. patients) and Kuala Lumpur, Malaysia.

At the same time, some countries with relatively weak domestic demand, such as China, Germany, South Korea, and Japan, focus on export-led economic growth, which drives many of their domestic businesses to become MNEs. For companies based in smaller economies, becoming an MNE may be necessary to achieve growth or to gain and sustain competitive advantage. Examples include Acer (Taiwan), Casella Wines (Australia), IKEA (featured in the ChapterCase), Nestlé (Switzerland), LEGO (Denmark), Philips (Netherlands), Samsung (South Korea), and Zara (Spain). Unless companies in smaller economies expand internationally, their domestic markets are often too small for them to reach significant economies of scale to compete effectively against other MNEs. Strategy Highlight 10.1 shows how the Persian Gulf airlines (all coming from small countries) are entering the much larger U.S. and international markets, competing directly with legacy carriers such as American, Delta, and United.

GAIN ACCESS TO LOW-COST INPUT FACTORS. MNEs that base their competitive advantage on a low-cost leadership strategy are particularly attracted to go overseas to gain

access to low-cost input factors. Access to low-cost raw *materials* such as lumber, iron ore, oil, and coal was a key driver behind Globalization 1.0 and 2.0. During Globalization 3.0, firms have expanded globally to benefit from lower *labor costs* in manufacturing and services. India carved out a competitive advantage in business process outsourcing (BPO), not only because of low-cost labor but also because of an abundance of well-educated, English-speaking young people. Infosys, TCS, and Wipro are some of the more well-known Indian IT service companies. Taken together, these companies employ more than 250,000 people and provide services to many of the Global Fortune 500 companies. Many MNEs have close business ties with Indian IT firms. Some, such as IBM, are engaged in foreign direct investment through equity alliances or building their own IT and customer service centers in India. More than a quarter of Accenture's work force, a consultancy specializing in technology and outsourcing, is now in Bangalore, India.²⁹ Both the CEOs of Google (Sundar Pichai) and Microsoft (Satya Nadella) hail from India.

Likewise, China has emerged as a manufacturing powerhouse because of low labor costs and an efficient infrastructure. An American manufacturing worker costs about 20 times more in wages alone than a similarly skilled worker in China.³⁰ A significant cost differential exists not only for low-skilled labor, but for high-skilled labor as well. A Chinese engineer trained at Purdue University, for example, works for only a quarter of the salary in his native country compared with an engineer working in the United States.³¹ Of course, this absolute wage disparity also reflects the relative difference in the two countries' cost of living.

DEVELOP NEW COMPETENCIES. Some MNEs pursue a global strategy in order to develop new competencies.³² This motivation is particularly attractive for firms that base their competitive advantage on a differentiation strategy. These companies are making foreign direct investments to be part of *communities of learning*, which are often contained in specific geographic regions.³³ AstraZeneca, a Swiss-based pharmaceutical company, relocated its research facility to Cambridge, Massachusetts, to be part of the Boston biotech cluster, in hopes of developing new R&D competencies in biotechnology.³⁴ Cisco invested more than \$1.6 billion to create an Asian headquarters in Bangalore and support other locations in India, in order to be in the middle of India's top IT location.³⁵ Likewise, Microsoft, the third-largest tech company globally (after Apple and Alphabet, Google's parent), has a key research center in Bangalore, India. Unilever's new-concept center is located in downtown Shanghai, China, attracting hundreds of eager volunteers to test the firm's latest product innovations on-site, while Unilever researchers monitor consumer reactions. In these examples, AstraZeneca, Cisco, Microsoft, and Unilever all reap **location economies**—benefits from locating value chain activities in optimal geographies for a specific activity, wherever that may be.³⁶

Many MNEs now are replacing the one-way innovation flow from Western economies to developing markets with a *polycentric innovation strategy*—a strategy in which MNEs now draw on multiple, equally important innovation hubs throughout the world characteristic of Globalization 3.0; see Exhibit 10.3. GE Global Research, for example, orchestrates a “network of excellence” with facilities in Niskayuna, New York (United States); Bangalore (India); Shanghai (China); and Munich (Germany). Indeed, emerging economies are becoming hotbeds for low-cost innovations that find their way back to developed markets.³⁷ In Bangalore, GE researchers developed the MAC 400, a handheld electrocardiogram (ECG).³⁸ The device is small, portable, and runs on batteries. Although a conventional ECG machine costs \$2,000, this handheld version costs \$800 and enables doctors to do an ECG test at a cost of only \$1 per patient. The MAC 400 is now entering the United States and other Western markets as a disruptive innovation, with anticipated widespread use in the offices of general practitioners and emergency ambulances.

location economies
Benefits from locating value chain activities in the world's optimal geographies for a specific activity, wherever that may be.



A GE team in China developed the Vscan, an inexpensive, portable ultrasound device, costing some \$5,000—rather than the \$250,000 cost of a traditional ultrasound machine used in Western hospitals. The Vscan is now widely used in rural areas of developing countries (as shown here in Vietnam) and has made its entry as a disruptive innovation in the United States and other rich countries.

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liability of foreignness
Additional costs of doing business in an unfamiliar cultural and economic environment, and of coordinating across geographic distances.

DISADVANTAGES OF GOING GLOBAL

Companies expanding internationally must carefully weigh the benefits and costs of doing so. If the cost of going global as captured by the following disadvantages exceeds the expected benefits in terms of value added ($C > V$), that is, if the economic value creation is negative, then firms are better off by not expanding internationally. Disadvantages to going global include

- Liability of foreignness.
- Loss of reputation.
- Loss of intellectual property.

LIABILITY OF FOREIGNNESS. In international expansion, firms face risks. In particular, MNEs doing business abroad also must overcome the **liability of foreignness**. This liability consists of the additional costs of doing business in an unfamiliar cultural and economic environment, and of coordinating across geographic distances.³⁹

For instance, Walmart's problems in several international markets are in large part because of the liability of foreignness. In particular, Walmart failed in Germany and experienced a similar fate in South Korea, where it also exited in 2006. In addition, Walmart has tried for many years to successfully enter the fast-growing markets in Russia and India, but with little or no success. Walmart's success recipe that worked so well domestically didn't work in Germany, South Korea, Russia, or India. Strategy Highlight 10.2 illustrates how Walmart underestimated its liability of foreignness when entering and competing in Germany, and how it is now facing the German grocery industry disruptors, Aldi and Lidl, on its home turf.

LOSS OF REPUTATION. One of the most valuable resources that a firm may possess is its reputation. A firm's reputation can have several dimensions, including a reputation for innovation, customer service, or brand reputation. Apple's brand, for example, stands for innovation and superior customer experience. Apple's reputation is also one of its most important resources. Apple's brand is valued at \$230 billion, making it (with Google's) one of the two most valuable brands in the world.⁴⁰ We detailed in Chapter 4 that a brand can be the basis for a competitive advantage if it is valuable, rare, and difficult to imitate.

While cost savings can generally be achieved, globalizing a supply chain can also have unintended side effects. These can lead to a loss of reputation and diminish the MNE's competitiveness. A possible loss in reputation can be a considerable risk and cost for doing business abroad. Because Apple's stellar consumer reputation is critical to its competitive advantage, it should be concerned about any potential negative exposure from its global activities. Problems at Apple's main supplier, Foxconn, brought this concern to the fore.

Low wages, long hours, and poor working and living conditions contributed to a spate of suicides in 2010 at Foxconn, Apple's main supplier in China.⁴¹ The Taiwanese company, which employs more than a million people, manufactures computers, tablets, smartphones, and other consumer electronics for Apple and other leading consumer electronics companies. The backlash against alleged sweatshop conditions in Foxconn prompted Apple to work with its main supplier to improve working conditions and wages. Tim Cook, Apple's CEO, visited Foxconn in China to personally inspect its manufacturing facility and workers' living conditions. Although conditions at Foxconn have been improving,⁴²

Strategy Highlight 10.2

Walmart Retreats from Germany, and Lidl Invades the United States

In 2006 and after spending billions of dollars, Walmart exited Germany in defeat. The eight-year failure shocked an otherwise successful company, and ghosts from the debacle now haunt Walmart on its native shores. What went wrong?

In 1998, Walmart faced a saturated U.S. market, and Germany, then the third-largest economy in the world, looked appealing. Walmart was already active in six foreign countries, with some 500 stores. Leadership decided the company's superior U.S. strategy—as the low-cost leader—would travel well one more time.

Walmart acquired Germany's 21-store Wertkauf chain and 74 hypermarkets from German retailer Spar Handels AG. And it followed the U.S. playbook: Walmart cheer, a door greeter, associates always available to customers, smiling and offering help, bagging groceries at the checkout, and so on. German employees, however, declined the transfusion of American values. No door greeters. Employees upheld the usual gruff standard of retail customer service found throughout Germany. Worse, the first Walmart boss in Germany—installed directly from the Arkansas headquarters—spoke no German. He decreed that English would be the official in-house language.

Cultural differences aside, Walmart also failed to keep prices down. The retailer lacked its domestic economies of scale and efficient distribution centers. Moreover, German labor laws—more protective than in the United States—drove up costs. The prices at Walmart in Germany were not “always low” despite the company slogan, but fell in the medium range.

Lastly, Walmart faced serious competition. Germany was already home to retail discount powerhouses such as Aldi and Lidl, with thousands of smaller outlets offering higher convenience combined with lower prices. Then it faced Metro, a large-box retailer, which started a price war when Walmart entered Germany. In the end, a defeated Walmart sold its stores to—guess who?—Metro!

One useful definition of strategy is to answer the question of how to deal with competition.⁴³ Walmart did not find a good strategy for competing with Aldi and Lidl in Germany. Now, Walmart is worried that Aldi and Lidl will challenge the world's largest retailer on its home turf. Aldi has been competing in the United States since the 1970s with its own Aldi stores (and its Trader Joe's brand). In 2017, Lidl also entered the United States.



Lidl, a German discounter, entered the United States in 2017. Together with Aldi, Lidl disrupted the grocery market in the United Kingdom. Walmart executives are concerned about a repeat in the United States.

©AP Images/Steve Helber

Why does Walmart worry about Lidl's entry into the U.S. grocery business? Aldi has been highly successful with its over 2,000 stores (and another 400-plus Trader Joe's stores) in the United States. Rather than focusing on large big-box outlets, Aldi stores are small, near urban centers with high foot traffic and easy access to public transportation or major roads to suburbia. Moreover, Trader Joe's, as a neighborhood grocery store, has a loyal fan base. It offers mainly its own brand-name products such as organic, vegetarian, or imported foods at much lower prices than Whole Foods and elsewhere. Trader Joe's generates twice as much revenue per square foot of retail space as Whole Foods.

Lidl is joining the fray. It already has a few dozen stores on the U.S. East Coast, with hundreds more planned. Similarly to Aldi, Lidl also competes on price and offers mainly its own store brands. Another advantage: These competitors typically offer 2,000 products rather than the standard 40,000 or so of large supermarkets. For example, many grocery stores sell 30 types of mustard. These German disruptors carry only two. Products arrive shelf-ready, minimizing stocking and inventory costs, albeit often with a wholesale feel. All products are sold at ultra-low prices. There are no daily or weekly specials.

Indeed, the entry of the German discounters was so successful in the United Kingdom that Tesco, Britain's leading supermarket chain, had to close dozens of stores, with large-scale layoffs. Its market cap fell almost 80 percent, from \$80 billion in 2007 to as low as \$17 billion in 2017.

(continued)

Meanwhile, Walmart prepares. With online sales, Walmart leads the German discounters, although it trails Amazon. Walmart's online sales grew by more than 50 percent in 2017. This growth comes in part from a new "order online, pick up in store" concept, with dedicated parking bays for drive-by customers to pick up online purchases. And it successfully improved Walmart.com, offering free, two-day delivery for orders over \$35.

Walmart is also working the basics to speed up checkout times and lower some prices even more. And it continues to

pressure suppliers so that its prices will be 15 percent lower than the competition's 80 percent of the time. With Amazon on one side (especially after its acquisition of Whole Foods Market) and industry disruptors such as Aldi and Lidl on the other, Walmart is sharpening its strategic position as a low-cost leader. This competitive battle is crucial for Walmart because groceries make up some 60 percent of its annual revenues of \$500 billion, making it the largest grocery chain in the United States.⁴⁴

Apple started to diversify its supplier base by adding Pegatron, another Taiwanese original equipment manufacturer (OEM).⁴⁵

MNEs' search for low-cost labor has had tragic effects where local governments are corrupt and unwilling or unable to enforce a minimum of safety standards. The textile industry is notorious for sweatshop conditions, and many Western companies such as the Gap (United States), H&M (Sweden), and Carrefour (France) have taken a big hit to their reputations in factory accidents in Bangladesh and elsewhere in Southeast Asia. Hundreds of factory workers were killed when a textile factory collapsed in Rana Plaza in 2013 on the outskirts of Dhaka, Bangladesh.⁴⁶ Although much of the blame lies with the often corrupt host governments not enforcing laws, regulations, and building codes, the MNEs that source their textiles in these factories also receive some of the blame with negative consequences for their reputation. The MNEs are accused of exploiting workers and being indifferent to their working conditions and safety, all in an unending quest to drive down costs.

This challenge directly concerns the MNEs' *corporate social responsibility (CSR)*, discussed in Chapter 2. Since some host governments are either unwilling or unable to enforce regulation and safety codes, MNEs need to rise to the challenge.⁴⁷ Walmart responded by posting a public list of "banned suppliers" on its website. These are suppliers that do not meet adequate safety standards and working conditions. Before the Rana Plaza accident, Walmart had already launched a working and fire-safety academy in Bangladesh to train textile workers.

Given the regulatory and legal void that local governments often leave, several Western MNEs have proposed a concerted action to finance safety efforts and worker training as well as structural upgrades to factory buildings. After earlier revelations about the frequent practice of child labor in many developing countries, Western MNEs in the textile industry worked together to ban their suppliers from using child labor. Ensuring ethical sourcing of raw materials and supplies is becoming ever more important. Besides a moral responsibility, MNEs have a market incentive to protect their reputations given the public backlash in the wake of factory accidents, child labor, worker suicides, and other horrific externalities.

LOSS OF INTELLECTUAL PROPERTY. Finally, the issue of protecting intellectual property in foreign markets also looms large. The software, movie, and music industries have long lamented large-scale copyright infringements in many foreign markets. In addition, when required to partner with a foreign host firm, companies may find their intellectual property being siphoned off and reverse-engineered.

Japanese and European engineering companies entered China to participate in building the world's largest network of high-speed trains worth billions of dollars.⁴⁸ Companies such as Kawasaki Heavy Industries (Japan), Siemens (Germany), and Alstom (France) were joint venture partners with domestic Chinese companies. These firms now allege that the Chinese partners built on the Japanese and European partners' advanced technology

to create their own, next-generation high-speed trains. To make matters worse, they also claim that the Chinese companies now compete against them in other lucrative markets, such as Saudi Arabia, Brazil, and even California, with trains of equal or better capabilities but offered at much lower prices. This example highlights the *intellectual property exposure* that firms can face when expanding overseas.

10.3 Going Global: Where and How?

After discussing why companies expand internationally, we now turn to the question of how to guide MNE decisions on which countries to enter and how to then enter those countries.

LO 10-3

Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

WHERE IN THE WORLD TO COMPETE? THE CAGE DISTANCE FRAMEWORK

The question of where to compete geographically is, following vertical integration and diversification, the third dimension of determining a firm's corporate strategy. The primary driver behind firms expanding beyond their domestic market is to strengthen their competitive position by gaining access to larger markets and low-cost input factors and to develop new competencies. So wouldn't companies choose new markets solely based on measures such as per capita consumption of the product and per capita income?

Yes and no. Consider that several countries and locations can score similarly on such *absolute* metrics of attractiveness. Ireland and Portugal, for example, have similar cost structures, and both provide access to some 500 million customers in the European Union. Both countries use the euro as a common currency, and both have a similarly educated work force and infrastructure. Given these similarities, how does an MNE decide? Rather than looking at absolute measures, MNEs need to consider *relative distance* in the CAGE model.

To aid MNEs in deciding where in the world to compete, Pankaj Ghemawat introduced the **CAGE distance framework**. CAGE is an acronym for different kinds of distance:

- Cultural.
- Administrative and political.
- Geographic.
- Economic.⁴⁹

Most of the costs and risks involved in expanding beyond the domestic market are created by *distance*. Distance not only denotes geographic distance (in miles or kilometers), but also includes, as the CAGE acronym points out, cultural distance, administrative and political distance, and economic distance. The CAGE distance framework breaks distance into different relative components between any two country pairs that affect the success of FDI.

Although absolute metrics such as country wealth or market size matter to some extent—as we know, for example, that a 1 percent increase in country wealth leads to a 0.8 percent increase in international trade—the relative factors captured by the CAGE distance model matter more. For instance, countries that are 5,000 miles apart trade only 20 percent of the amount traded among countries that are 1,000 miles apart. Cultural distance matters even more. A common language increases trade between two countries by 200 percent over country pairs without one. Thus, in the earlier example regarding which EU country to select for FDI, a U.S. MNE should pick Ireland, while a Brazilian MNE should select Portugal. In the latter case, Brazil and Portugal also share a historic colony-colonizer

CAGE distance

framework A decision framework based on the relative distance between home and a foreign target country along four dimensions: cultural distance, administrative and political distance, geographic distance, and economic distance.

EXHIBIT 10.5 / The CAGE Distance Framework

Distance	C Cultural	A Administrative and Political	G Geographic	E Economic
Between two countries increases with . . .	• Different languages, ethnicities, religions, social norms, and dispositions • Lack of connective ethnic or social networks • Lack of trust and mutual respect	• Absence of trading bloc • Absence of shared currency, monetary or political association • Absence of colonial ties • Political hostilities • Weak legal and financial institutions	• Lack of common border, waterway access, adequate transportation, or communication links • Physical remoteness • Different climates and time zones	• Different consumer incomes • Different costs and quality of natural, financial, and human resources • Different information or knowledge
Most affects industries or products . . .	• With high linguistic content (TV) • Related to national and/or religious identity (foods) • Carrying country-specific quality associations (wines)	• That a foreign government views as staples (electricity), as building national reputations (aerospace), or as vital to national security (telecommunications)	• With low value-to-weight ratio (cement) • That are fragile or perishable (glass, meats) • In which communications are vital (financial services)	• For which demand varies by income (cars) • In which labor and other cost differences matter (textiles)

SOURCE: Adapted from P. Ghemawat (2001), "Distance still matters: The hard reality of global expansion," *Harvard Business Review*, September: 137–147.

relationship. This link increases the expected trade intensity between these two countries by yet another 900 percent in comparison to country pairs where absent.

Other CAGE distance factors are significant in predicting the amount of trade between two countries. If the countries belong to the same regional trading bloc, they can expect another 330 percent in trade intensity. Examples include the United States, Canada, and Mexico in NAFTA, or the member states of the European Union. If the two countries use the same currency it increases trade intensity by 340 percent. An example is use of the euro as the common currency in 19 EU countries.⁵⁰

Exhibit 10.5 presents the CAGE distance model. In particular, it details factors that increase the overall distance between the two countries and how distance affects different industries or products along the CAGE dimensions.⁵¹ Next, we briefly discuss each of the CAGE distance dimensions.⁵²

CULTURAL DISTANCE. In his seminal research, Geert Hofstede defined and measured **national culture**, the collective mental and emotional "programming of the mind" that differentiates human groups.⁵³ Culture is made up of a collection of social norms and mores, beliefs, and values. Culture captures the often unwritten and implicitly understood rules of the game.

Although there is no one-size-fits-all culture that accurately describes any nation, Hofstede's work provides a useful tool to proxy cultural distance. Based on data analysis

national culture The collective mental and emotional "programming of the mind" that differentiates human groups.

from more than 100,000 individuals from many different countries, four main dimensions of culture emerged: *Power distance*, *individualism*, *masculinity-femininity*, and *uncertainty avoidance*.⁵⁴ Hofstede's data analysis yielded scores for the different countries, for each dimension, on a range of zero to 100, with 100 as the high end. More recently, Hofstede added two additional cultural dimensions: *long-term orientation* and *indulgence*.⁵⁵

Cultural differences find their expression in language, ethnicity, religion, and social norms. They directly affect customer preferences (see Exhibit 10.5). Because of religious beliefs, for example, Hindus do not eat beef, while Muslims do not eat pork. In terms of content-intensive service, cultural and language differences are also the reason global internet companies such as Amazon or Google offer country-specific variations of their sites. Despite these best efforts, they are often outflanked by native providers because of their deeper cultural understanding. For example, in China the leading websites are domestic ones: Alibaba in ecommerce, and Baidu in online search. In Russia, the leading ecommerce site is Ozon, while the leading search engine is Yandex.

Hofstede's national-culture research becomes even more useful for managers by combining the distinct dimensions of culture into an aggregate measure for each country. MNEs then can compare the national-culture measures for any two country pairings to inform their entry decisions.⁵⁶ The difference between scores indicates **cultural distance**, the cultural disparity between the internationally expanding firm's home country and its targeted host country. A firm's decision to enter certain international markets is influenced by cultural differences. A greater cultural distance can increase the cost and uncertainty of conducting business abroad. In short, greater cultural distance increases the liability of foreignness.

If we calculate the cultural distance from the United States to various countries, for example, we find that some countries are culturally very close to the United States. Australia, for example, has an overall cultural distance score of 0.02. Others are culturally quite distant. Russia has an overall cultural distance score of 4.42. As can be expected, English-speaking countries such as Canada (0.12), Ireland (0.35), New Zealand (0.26), and the United Kingdom (0.09) all exhibit a low cultural distance to the United States. Since culture is embedded in language, it comes as no surprise that cultural and linguistic differences are highly correlated.

Culture even matters in the age of Facebook with its global reach of 2 billion users. Most Facebook friends are local rather than across borders. This makes sense when one considers that the online social graph that Facebook users develop in their network of friends is actually a virtual network laid above a (pre)existing social network, rather than forming one anew.⁵⁷

ADMINISTRATIVE AND POLITICAL DISTANCE. Administrative and political distances are captured in factors such as the absence or presence of shared monetary or political associations, political hostilities, and weak or strong legal and financial institutions.⁵⁹

cultural distance

Cultural disparity between an internationally expanding firm's home country and its targeted host country.



In 2000 when Starbucks entered the Chinese market, it moved fast to overcome cultural barriers by handing out key chains to help new customers order! Now it leverages Chinese approaches to social media (WeChat, Weibo, and Jiebang) and fine-tunes its own mobile apps and loyalty programs to lure China's growing middle class. The result? Today China is its second-largest market and growing.⁵⁸ Courtesy of Resonance China

The 19 European countries in the eurozone, for example, not only share the same currency but also integrate politically to some extent. It should come as no surprise then that most cross-border trade between European countries takes place within the EU. Germany, one of the world's largest exporters, conducts roughly 75 percent of its cross-border business within the EU.⁶⁰ Similarly, Canada and Mexico partner with the United States in the North American Free Trade Agreement (NAFTA), increasing trade in goods and services between the three countries. As a result, United States is the largest trading partner for both Canada and Mexico. After China, Canada and Mexico are the largest trading partners for the United States. Colony–colonizer relationships also have a strong positive effect on bilateral trade between countries. British companies continue to trade heavily with businesses from its former colonies in the commonwealth; Spanish companies trade heavily with Latin American countries; and French businesses trade with the franc zone of West Africa.

Many foreign (target) countries also erect other political and administrative barriers, such as tariffs, trade quotas, FDI restrictions, and so forth, to protect domestic competitors. In many instances, China, for example, requests the sharing of technology in a joint venture when entering the country. This was the case in the high-speed train developments discussed earlier. Other countries, including the United States and EU members, protect national champions such as Boeing or Airbus from foreign competition. Industries that are considered critical to national security—domestic airlines or telecommunications—are often protected. Finally, strong legal and ethical pillars as well as well-functioning economic institutions such as capital markets and an independent central bank reduce distance. Strong institutions, both formal and informal, reduce uncertainty and thus reduce transaction costs.⁶¹

GEOGRAPHIC DISTANCE. The costs to cross-border trade rise with geographic distance. It is important to note, however, that geographic distance does not simply capture how far two countries are from each other but also includes additional attributes, such as the country's physical size (Canada versus Singapore), the within-country distances to its borders, the country's topography, its time zones, and whether the countries are contiguous to one another or have access to waterways and the ocean. The country's infrastructure, including road, power, and telecommunications networks, also plays a role in determining geographic distance. Geographic distance is particularly relevant when trading products with low value-to-weight ratios, such as steel, cement, or other bulk products, and fragile and perishable products, such as glass or fresh meats and fruits.

ECONOMIC DISTANCE. The wealth and per capita income of consumers is the most important determinant of economic distance. Wealthy countries engage in relatively more cross-border trade than poorer ones. Rich countries tend to trade with other rich countries; in addition, poor countries also trade more frequently with rich countries than with other poor countries. Companies from wealthy countries benefit in cross-border trade with other wealthy countries when their competitive advantage is based on *economies of experience, scale, scope, and standardization*. This is because replication of an existing business model is much easier in a country where the incomes are relatively similar and resources, complements, and infrastructure are of roughly equal quality. Although Walmart in Canada is a virtual carbon copy of the Walmart in the United States, Walmart in China is quite different.⁶²

Companies from wealthy countries also trade with companies from poor countries to benefit from *economic arbitrage*. The textile industry (discussed earlier) is a prime example. We also highlighted economic arbitrage as one of the main benefits of going global: access to low-cost input factors.

In conclusion, although the CAGE distance framework helps determine the attractiveness of foreign target markets in a more fine-grained manner based on relative differences,

it is necessarily only a first step. A deeper analysis requires looking inside the firm (as done in Chapter 4) to see how a firm's strengths and weaknesses work to increase or reduce distance from specific foreign markets. A company with a large cadre of cosmopolitan managers and a diverse work force will be much less affected by cultural differences, for example, than a company with a more insular and less diverse culture with all managers from the home country. Although technology may make the world seem smaller, the costs of distance along all its dimensions are real. The costs of distance in expanding internationally are often very high. Ignoring these costs can be expensive (see Walmart's adventure in Germany, discussed in Strategy Highlight 10.2) and can lead to a competitive disadvantage.

HOW DO MNEs ENTER FOREIGN MARKETS?

Assuming an MNE has decided why and where to enter a foreign market, the remaining decision is *how* to do so. Exhibit 10.6 displays the different options managers have when entering foreign markets, along with the required investments necessary and the control they can exert. On the left end of the continuum in Exhibit 10.6 are vehicles of foreign expansion that require low investments but also allow for a low level of control. On the right are foreign-entry modes that require a high level of investments in terms of capital and other resources, but also allow for a high level of control. Foreign-entry modes with a high level of control such as foreign acquisitions or greenfield plants reduce the firm's exposure to two particular downsides of global business: loss of reputation and loss of intellectual property.

Exporting—producing goods in one country to sell in another—is one of the oldest forms of internationalization (part of Globalization 1.0). It is often used to test whether a foreign market is ready for a firm's products. When studying vertical integration and diversification (in Chapter 8), we discussed in detail different forms along the make-or-buy continuum. As discussed in Chapter 9, strategic alliances (including licensing, franchising, and joint ventures) and acquisitions are popular vehicles for entry into foreign markets. Since we discussed these organizational arrangements in detail in previous chapters, we therefore keep this section on foreign-entry modes brief.

The framework illustrated in Exhibit 10.6, moving from left to right, has been suggested as a *stage model* of sequential commitment to a foreign market over time.⁶³ Though it does not apply to globally born companies, it is relevant for manufacturing companies that are just now expanding into global operations. In some instances, companies are required by the host country to form joint ventures in order to conduct business there, while some MNEs prefer *greenfield operations*—building new, fully owned plants and facilities from scratch, as Motorola did when it entered China in the 1990s.⁶⁴

LO 10-4

Compare and contrast the different options MNEs have to enter foreign markets.

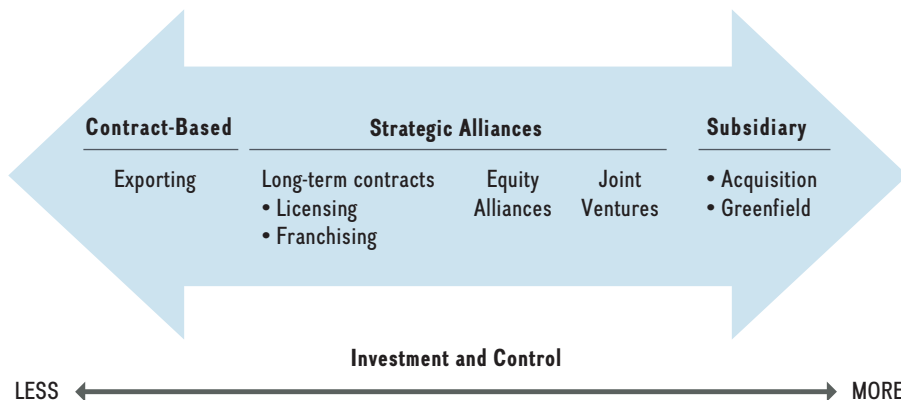


EXHIBIT 10.6

Modes of Foreign-Market Entry along the Investment and Control Continuum

LO 10-5

Apply the integration-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

globalization hypothesis

Assumption that consumer needs and preferences throughout the world are converging and thus becoming increasingly homogenous.

local responsiveness

The need to tailor product and service offerings to fit local consumer preferences and host-country requirements.

integration-responsiveness framework

Strategy framework that juxtaposes the pressures an MNE faces for cost reductions and local responsiveness to derive four different strategies to gain and sustain competitive advantage when competing globally.

10.4 Cost Reductions vs. Local Responsiveness: The Integration-Responsiveness Framework

MNEs face two opposing forces when competing around the globe: *cost reductions* versus *local responsiveness*. Indeed, cost reductions achieved through a global-standardization strategy often reinforce a cost-leadership strategy at the business level. Similarly, local responsiveness increases the differentiation of products and services, reinforcing a differentiation strategy at the business level. Taken together, however, cost reductions and local responsiveness present strategic trade-offs because higher local responsiveness frequently goes along with higher costs. Conversely, a focus on cost reductions does not allow for much local responsiveness. Just like low cost and differentiation at the business strategy level, cost reductions and local responsiveness are trade-offs when competing globally.

One of the core drivers for globalization is to expand the total market of firms in order to achieve economies of scale and drive down costs. For many business executives, the move toward globalization is based on the **globalization hypothesis**, which states that consumer needs and preferences throughout the world are converging and thus becoming increasingly homogenous. Theodore Levitt stated: “Nothing confirms [the globalization hypothesis] as much as the success of McDonald’s from [the] Champs-Élysées to Ginza, of Coca-Cola in Bahrain and Pepsi-Cola in Moscow, and of rock music, Greek salad, Hollywood movies, Revlon cosmetics, Sony televisions, and Levi jeans everywhere.”⁶⁵ In support of the globalization hypothesis, IKEA, as featured in the ChapterCase, sells its home furnishings successfully in over 40 countries. Toyota is selling its hybrid Prius vehicle in 80 countries. Most vehicles today are built on global platforms and modified (sometimes only cosmetically) to meet local tastes and standards.

The strategic foundations of the globalization hypothesis are based primarily on cost reduction. Lower cost is a key competitive weapon, and MNEs attempt to reap significant cost reductions by leveraging economies of scale and by managing global supply chains to access the lowest-cost input factors.

Although there seems to be some convergence of consumer preferences across the globe, national differences remain, due to distinct institutions and cultures. For example, in the 1990s, Ford Motor Co. followed this one-size-fits-all strategy by offering a more or less identical car throughout the world: the Ford Mondeo, sold as the Ford Contour and the Mercury Mystique in North America. Ford learned the hard way, by lack of sales, that consumers did not subscribe to the globalization hypothesis at the same level as the Ford executives and were not yet prepared to ignore regional differences.⁶⁶ In some instances, MNEs experience pressure for **local responsiveness**—the need to tailor product and service offerings to fit local consumer preferences and host-country requirements; it generally entails higher costs. Walmart sells live animals (snakes, eels, toads, etc.) for food preparation in China. IKEA sells kimchi refrigerators and metal chopsticks in South Korea. McDonald’s uses chicken and fish instead of beef in India and offers a teriyaki burger in Japan, even though its basic business model of offering fast food remains the same the world over. Local responsiveness generally entails higher cost, and sometimes even outweighs cost advantages from economies of scale and lower-cost input factors.

Given the two opposing pressures of cost reductions versus local responsiveness, scholars have advanced the **integration-responsiveness framework**, shown in Exhibit 10.7.⁶⁷ This framework juxtaposes the opposing pressures for cost reductions and local responsiveness to derive four different strategic positions to gain and sustain competitive advantage when competing globally. The four strategic positions, which we will discuss in the following sections, are

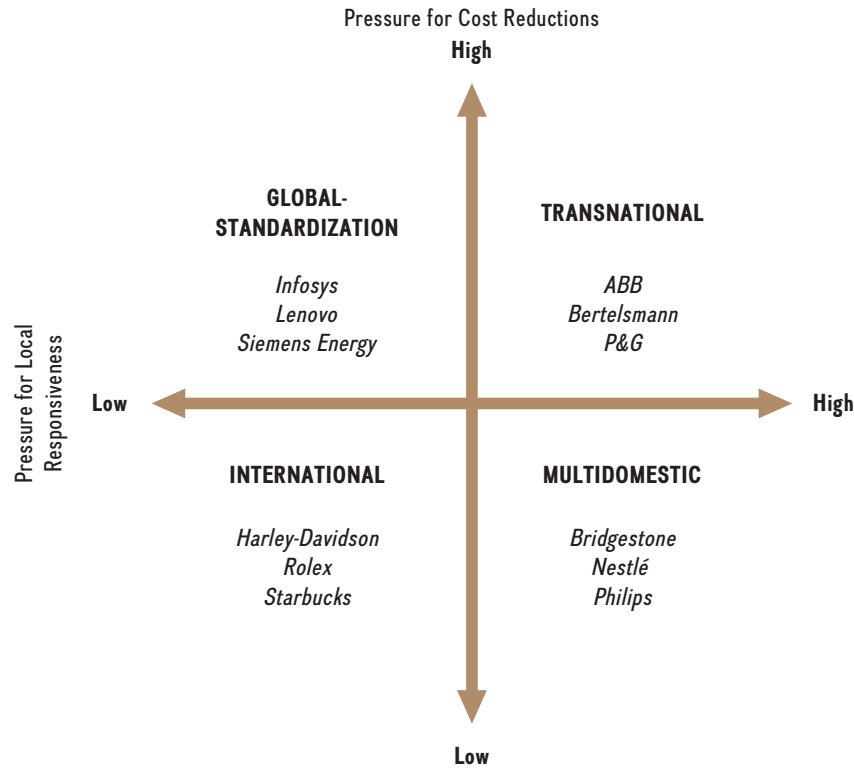


EXHIBIT 10.7 /

The Integration-Responsiveness Framework: Global Strategy Positions and Representative MNEs

SOURCES: C.K. Prahalad and Y.L. Doz (1987), *The Multinational Mission* (New York: Free Press); and K. Roth and A.J. Morrison (1991), "An empirical analysis of the integration-responsiveness framework in global industries," *Journal of International Business Studies* 21: 541-564.

- International
- Multidomestic
- Global-standardization
- Transnational⁶⁸

At the end of that discussion, Exhibit 10.9 summarizes each global strategy.

INTERNATIONAL STRATEGY

An **international strategy** is essentially a strategy in which a company sells the same products or services in both domestic and foreign markets. It enables MNEs to leverage their home-based core competencies in foreign markets. An international strategy is one of the oldest types of global strategies (Globalization 1.0) and is frequently the first step companies take when beginning to conduct business abroad. As shown in the integration-responsiveness framework, it is advantageous when the MNE faces low pressures for both local responsiveness and cost reductions.

An international strategy is often used successfully by MNEs with relatively large domestic markets and with strong reputations and brand names. These MNEs, capitalizing on the fact that foreign customers want to buy the original product, tend to use differentiation as their preferred business strategy. For example, bikers in Shanghai, China, like their Harley-Davidson motorcycles to roar just like the ones ridden by the Hells Angels in the United States. Similarly, a Brazilian entrepreneur importing machine tools from Germany expects superior engineering and quality. Finally, Apple's latest iPhone model is a desired luxury product and status symbol the world over. An international strategy tends to rely

international strategy
Strategy that involves leveraging home-based core competencies by selling the same products or services in both domestic and foreign markets.

on exporting or the licensing of products and franchising of services to reap economies of scale by accessing a larger market.

A strength of the international strategy—its limited local responsiveness—is also a weakness in many industries. For example, when an MNE sells its products in foreign markets with little or no change, it leaves itself open to the expropriation of intellectual property (IP). Looking at the MNE's products and services, pirates can reverse-engineer the products to discover the intellectual property embedded in them. In Thailand, for example, a flourishing market for knockoff luxury sports cars (e.g., Ferraris, Lamborghinis, and Porsches) has sprung up.⁶⁹ Besides the risk of exposing IP, MNEs following an international strategy are highly affected by exchange-rate fluctuations. Given increasing globalization, however, fewer and fewer markets correspond to this situation—low pressures for local responsiveness *and* cost reductions—that gives rise to the international strategy.

MULTIDOMESTIC STRATEGY

multidomestic strategy Strategy pursued by MNEs that attempts to maximize local responsiveness, with the intent that local consumers will perceive them to be domestic companies.

MNEs pursuing a **multidomestic strategy** attempt to maximize local responsiveness, hoping that local consumers will perceive their products or services as local ones. This strategy arises out of the combination of high pressure for local responsiveness and low pressure for cost reductions. MNEs frequently use a multidomestic strategy when entering host countries with large and/or idiosyncratic domestic markets, such as Japan or Saudi Arabia. This is one of the main strategies MNEs pursued in the Globalization 2.0 stage.

A multidomestic strategy is common in the consumer products and food industries. For example, Swiss-based Nestlé, the largest food company in the world, is known for customizing its product offerings to suit local preferences, tastes, and requirements. Given the strong brand names and core competencies in R&D, and the quality in their consumer products and food industries, it is not surprising that these MNEs generally pursue a differentiation strategy at the business level. An MNE following a multidomestic strategy, in contrast with an international strategy, faces reduced exchange-rate exposure because the majority of the value creation takes place in the host-country business units, which tend to span all functions.

On the downside, a multidomestic strategy is costly and inefficient because it requires the duplication of key business functions across multiple countries. Each country unit tends to be highly autonomous, and the MNE is unable to reap economies of scale or learning across regions. The risk of IP appropriation increases when companies follow a multidomestic strategy. Besides exposing codified knowledge embedded in products, as is the case with an international strategy, a multidomestic strategy also requires exposing tacit knowledge because products are manufactured locally. Tacit knowledge that is at risk of appropriation may include, for example, the process of how to create consumer products of higher perceived quality.

GLOBAL-STANDARDIZATION STRATEGY

global-standardization strategy Strategy attempting to reap significant economies of scale and location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost.

MNEs following a **global-standardization strategy** attempt to reap significant economies of scale and location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. The global-standardization strategy arises out of the combination of high pressure for cost reductions and low pressure for local responsiveness. MNEs using this strategy are often organized as networks (Globalization 3.0). This lets them strive for the lowest-cost position possible. Their business-level strategy tends to be cost leadership. Because there is little or no differentiation or local responsiveness because products are standardized, price becomes the main competitive weapon. To be price competitive, the MNE must maintain a minimum efficient scale (see Chapter 6).

MNEs that manufacture commodity products such as computer hardware or offer services such as business process outsourcing generally pursue a global-standardization

strategy. Lenovo, the Chinese computer manufacturer, is the maker of the ThinkPad line of laptops, which it acquired from IBM in 2005. To keep track of the latest developments in computing, Lenovo's research centers are located in Beijing and Shanghai in China, in Raleigh, North Carolina (in the Research Triangle Park), and in Japan.⁷⁰ To benefit from low-cost labor and to be close to its main markets to reduce shipping costs, Lenovo's manufacturing facilities are in Mexico, India, and China. The company describes the benefits of its global-standardization strategy insightfully: "Lenovo organizes its worldwide operations with the view that a truly global company must be able to quickly capitalize on new ideas and opportunities from anywhere. By forgoing a traditional headquarters model and focusing on centers of excellence around the world, Lenovo makes the maximum use of its resources to create the best products in the most efficient and effective way possible."⁷¹

One of the advantages of the global-standardization strategy—obtaining the lowest cost point possible by minimizing local adaptations—is also one of its key weaknesses. The American MTV network cable channel started out with a global-standardization strategy.⁷² The main inputs—music videos by vocal artists—were sourced more or less globally based on the prevailing music hits. MTV reasoned that music videos were a commodity product that would attract worldwide audiences. MTV was wrong! As indicated by the CAGE distance model, cultural distance most affects products with high linguistic content such as TV. Even in a music video channel, audiences have a distinct preference for at least some local content.

Keep in mind that strategic positions are not constant; they can change over time. Consider how MTV changed its strategic positions as it attempted to respond to the pressures for both cost reduction and local responsiveness. At first, MTV followed a global-standardization strategy. To be more responsive to local audiences, MTV then implemented a multidomestic strategy to meet the need for local responsiveness. This led to a loss of scale effects, especially rolling out expensive content over a large installed base of viewers. In a move a few years later, MTV shifted its strategic position away from a multidomestic strategy and is now pursuing a transnational strategy. Exhibit 10.8 tracks how MTV changed strategic positions in its quest for competitive advantage.

TRANSNATIONAL STRATEGY

MNEs pursuing a **transnational strategy** attempt to combine the benefits of a localization strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable). This strategy arises out of the combination of high pressure for local responsiveness and high pressure for cost reductions. A transnational strategy is generally used by MNEs that pursue a blue ocean strategy at the business level by attempting to reconcile product and/or service differentiations at low cost.

Besides harnessing economies of scale and location, a transnational strategy also aims to benefit from global learning. MNEs typically implement a transnational strategy through a global matrix structure. This organizational structure combines economies of scale along specific product divisions with economies of learning attainable in specific geographic regions. The idea is that best practices, ideas, and innovations will be diffused throughout the world, regardless of their origination. The managers' mantra is to *think globally, but act locally*.

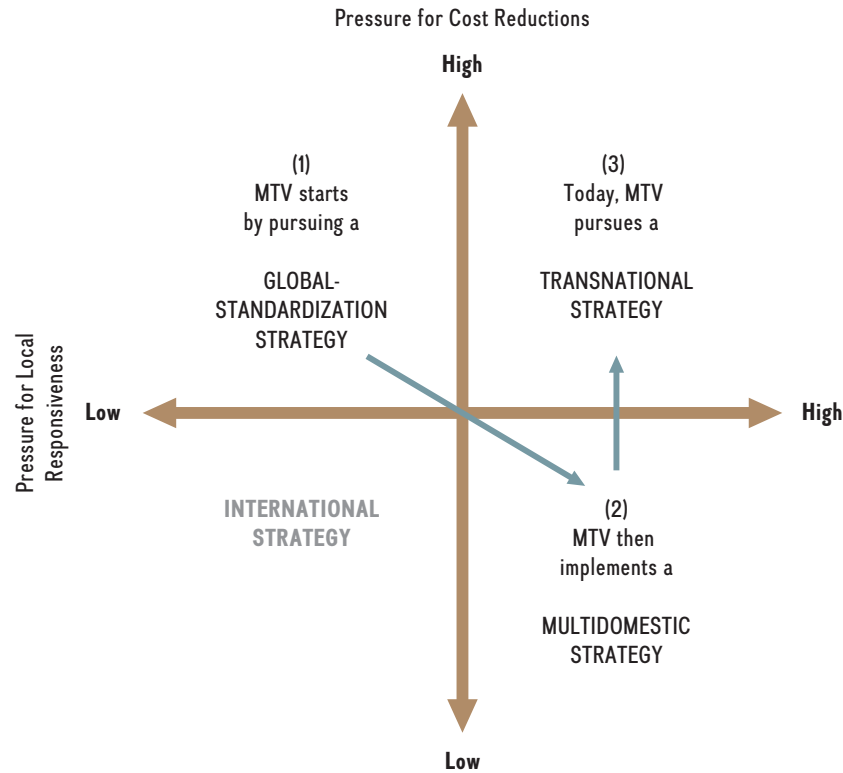
Although a transnational strategy is quite appealing, the required matrix structure is rather difficult to implement because of the organizational complexities involved. High local responsiveness typically requires that key business functions are frequently duplicated in each host country, leading to higher costs. Further compounding the organizational complexities is the challenge of finding managers who can dexterously work across cultures in the ways required by a transnational strategy. We'll discuss organizational structure in more depth in the next chapter.

The German multimedia conglomerate Bertelsmann attempts to follow a transnational strategy. Bertelsmann employs over 100,000 people, with two-thirds of that work force

transnational strategy
Strategy that attempts to combine the benefits of a localization strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable).

EXHIBIT 10.8 /

Dynamic Strategic
Positioning: The MTV
Music Channel



outside its home country. Bertelsmann operates in more than 60 countries throughout the world and owns many regional leaders in their specific product categories, including Random House Publishing in the United States and RTL Group, Europe's second-largest TV, radio, and production company (after the BBC). Bertelsmann operates its over 500 regional media divisions as more or less autonomous profit-and-loss centers but attempts to share best practices across units; global learning and human resource strategies for executives are coordinated at the network level.⁷³

As a summary, Exhibit 10.9 provides a detailed description of each of the four global strategies in the integration-responsiveness framework.

10.5 National Competitive Advantage: World Leadership in Specific Industries

Globalization, the prevalence of the internet with other advances in communications technology, and transportation logistics can lead us to believe that firm location is becoming increasingly less important.⁷⁴ Because firms can now, more than ever, source inputs globally, many believe that location must be diminishing in importance as an explanation of firm-level competitive advantage. This idea is called the **death-of-distance hypothesis**.⁷⁵

Despite an increasingly globalized world, however, it turns out that high-performing firms in certain industries *are* concentrated in specific countries.⁷⁶ For example, the leading biotechnology, software, and internet companies are headquartered in the United States. Some of the world's best computer manufacturers are in China and Taiwan. Many of the leading consumer electronics companies are in South Korea and Japan. The top mining companies are in Australia. The leading business process outsourcing (BPO) companies are in India. Some of the best engineering and car companies are in Germany. The world's top fashion designers are in Italy. The best wineries are in France. The list goes on. Although

death-of-distance hypothesis Assumption that geographic location alone should not lead to firm-level competitive advantage because firms are now, more than ever, able to source inputs globally.

EXHIBIT 10.9 / International, Multidomestic, Global-Standardization, and Transnational Strategies: Characteristics, Benefits, and Risks

Strategy	Characteristics	Benefits	Risks
International	Often the first step in internationalizing. Used by MNEs with relatively large domestic markets or strong exporters (e.g., MNEs from the United States, Germany, Japan, South Korea). Well-suited for high-end products with high value-to-weight ratios such as machine tools and luxury goods that can be shipped across the globe. Products and services tend to have strong brands. Main business-level strategy tends to be differentiation because exporting, licensing, and franchising add additional costs.	Leveraging core competencies. Economies of scale. Low-cost implementation through: • Exporting or licensing (for products) • Franchising (for services) • Licensing (for trademarks)	No or limited local responsiveness. Highly affected by exchange-rate fluctuations. IP embedded in product or service could be expropriated.
Multidomestic	Used by MNEs to compete in host countries with large and/or lucrative but idiosyncratic domestic markets (e.g., Germany, Japan, Saudi Arabia). Often used in consumer products and food industries. Main business-level strategy is differentiation. MNE wants to be perceived as local company.	Highest-possible local responsiveness. Increased differentiation. Reduced exchange-rate exposure.	Duplication of key business functions in multiple countries leads to high cost of implementation. Little or no economies of scale. Little or no learning across different regions. Higher risk of IP expropriation.
Global-Standardization	Used by MNEs that are offering standardized products and services (e.g., computer hardware or business process outsourcing). Main business-level strategy is cost leadership.	Location economies: global division of labor based on wherever best-of-class capabilities reside at lowest cost. Economies of scale and standardization.	No local responsiveness. Little or no product differentiation. Some exchange-rate exposure. “Race to the bottom” as wages increase. Some risk of IP expropriation.
Transnational	Used by MNEs that pursue a blue ocean strategy at the business level by simultaneously focusing on product differentiation and low cost. Mantra: Think globally, act locally.	Attempts to combine benefits of localization and standardization strategies simultaneously by creating a global matrix structure. Economies of scale, location, experience, and learning.	Global matrix structure is costly and difficult to implement, leading to high failure rate. Some exchange-rate exposure. Higher risk of IP expropriation.

globalization lowers the barriers to trade and investments and increases human capital mobility, one key question remains: *Why are certain industries more competitive in some countries than in others?* This question goes to the heart of the issue of **national competitive advantage**, a consideration of world leadership in specific industries. That issue, in

national competitive advantage World leadership in specific industries.

turn, has a direct effect on firm-level competitive advantage. Companies from home countries that are world leaders in specific industries tend to be the strongest competitors globally.

PORTER'S DIAMOND FRAMEWORK

LO 10-6

Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

Michael Porter advanced a framework to explain national competitive advantage—why some nations outperform others in specific industries. This framework is called Porter's diamond of national competitive advantage. As shown in Exhibit 10.10, it consists of four interrelated factors:

- Factor conditions.
- Demand conditions.
- Competitive intensity in focal industry.
- Related and supporting industries/complementors.

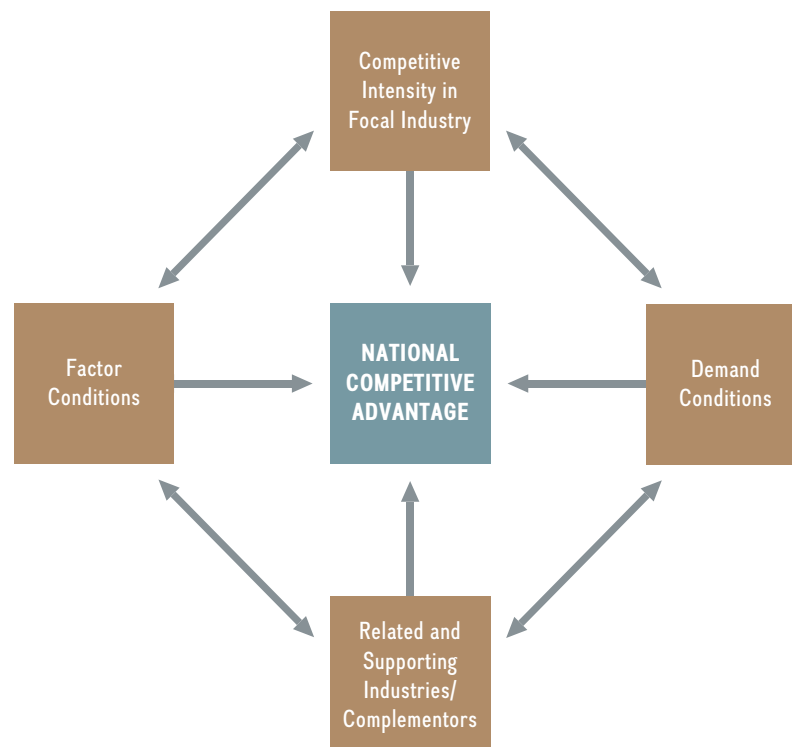
FACTOR CONDITIONS. *Factor conditions* describe a country's endowments in terms of natural, human, and other resources. Other important factors include capital markets, a supportive institutional framework, research universities, and public infrastructure (airports, roads, schools, health care system), among others.

Interestingly, *natural resources* are often not needed to generate world-leading companies, because competitive advantage is often based on other factor endowments such as human capital and know-how. Several of the world's most resource-rich countries (such as Afghanistan,⁷⁷ Iran, Iraq, Russia, Saudi Arabia, and Venezuela) are not home to any of the world's leading companies, even though some (though not all) do have in place

EXHIBIT 10.10

Porter's Diamond of National Competitive Advantage

SOURCE: Adapted from M.E. Porter (1990), "The competitive advantage of nations," *Harvard Business Review*, March–April: 78.



institutional frameworks allowing them to be a productive member of world commerce. In contrast, countries that lack natural resources (e.g., Denmark, Finland, Israel, Japan, Singapore, South Korea, Switzerland, Taiwan, and the Netherlands) often develop world-class human capital to compensate.⁷⁸

DEMAND CONDITIONS. *Demand conditions* are the specific characteristics of demand in a firm's domestic market. A home market made up of sophisticated customers who hold companies to a high standard of value creation and cost containment contributes to national competitive advantage. Moreover, demanding customers may also clue firms into the latest developments in specific fields and may push firms to move research from basic findings to commercial applications for the marketplace.

For example, due to dense urban living conditions, hot and humid summers, and high energy costs, it is not surprising that Japanese customers demand small, quiet, and energy-efficient air conditioners. In contrast to the Japanese, Finns have a sparse population living in a more remote countryside. A lack of landlines for telephone service has resulted in the Finnish demand for high-quality wireless services, combined with reliable handsets (and long-life batteries) that can be operated in remote, often hostile, environments. Cell phones have long been a necessity for survival in rural areas of Finland. This situation enabled Nokia to become an early leader in cell phones.⁷⁹

COMPETITIVE INTENSITY IN A FOCAL INDUSTRY. Companies that face a highly competitive environment at home tend to outperform global competitors that lack such intense domestic competition. Fierce domestic competition in Germany, for example, combined with demanding customers and the no-speed-limit autobahn make a tough environment for any car company. Success requires top-notch engineering of chassis and engines, as well as keeping costs and fuel consumption (\$6-per-gallon gas) in check. This extremely tough home environment amply prepared German car companies such as Volkswagen (which also owns Audi and Porsche), BMW, and Daimler for global competition.

RELATED AND SUPPORTING INDUSTRIES/COMPLEMENTORS. Leadership in related and supporting industries can also foster world-class competitors in downstream industries. The availability of top-notch *complementors*—firms that provide a good or service that leads customers to value the focal firm's offering more when the two are combined—further strengthens national competitive advantage. Switzerland, for example, leveraged its early lead in industrial chemicals into pharmaceuticals.⁸⁰ A sophisticated health care service industry sprang up alongside as an important complementor, to provide further stimulus for growth and continuous improvement and innovation.

The effects of sophisticated customers and highly competitive industries ripple through the industry value chain to create top-notch suppliers and complementors. Toyota's global success in the 1990s and early 2000s was based to a large extent on a network of world-class suppliers in Japan.⁸¹ This tightly knit network allowed for fast two-way knowledge sharing—this in turn improved Toyota's quality and lowered its cost, which it leveraged into a successful blue ocean strategy at the business level.

It is also interesting to note that by 2010, Toyota's supplier advantage had disappeared.⁸² It was unable to solve the trade-off between drastically increasing its volume and maintaining superior quality. Toyota's rapid growth in its quest to become the world's leader in volume required quickly bringing on new suppliers outside Japan. Quality standards, however, could not be maintained. Part of the problem lies in path dependence (discussed in Chapter 4), because Chinese and other suppliers could not be found quickly enough, nor could most foreign suppliers build at the required quality levels fast enough. The cultural

distance between Japan and China exacerbated these problems. Combined, these factors explain the quality problems Toyota experienced in recent years, and highlight the importance of related and supporting industries to national competitive advantage.

10.6 Implications for Strategic Leaders

In addition to determining the degree of vertical integration and level of diversification, the strategic leader needs to decide if and how the firm should compete beyond its home market. Decisions along all three dimensions formulate the firm's corporate strategy. Because of increasing global integration in products and services as well as capital markets, the benefits of competing globally outweigh the costs for more and more enterprises. This is true not just for large MNEs, but also for small and medium ones (SMEs). Even small startups are now able to leverage technology such as the internet to compete beyond their home market.

Strategic leaders have a number of frameworks at their disposal to make global strategy decisions. The CAGE framework allows for a detailed analysis of any country pairing. Rather than looking at simple absolute measures such as market size, the strategist can determine the *relative* distance or closeness of a target market to the home market along cultural, administrative/political, geographic, and economic dimensions. Once decided which countries to enter, the *mode* of foreign entry needs to be determined. Considerations of the degree of investment and level of control help in this decision. Higher levels of control, and thus greater protection of IP and a lower likelihood of any loss in reputation, go along with more investment-intensive foreign-entry modes such as acquisitions or green-field plants (see Exhibit 10.6).

A firm's business-level strategy (discussed in Chapter 6) provides an important clue to possible strategies to be pursued globally. A cost leader, for example, is more likely to have the capabilities to be successful with a global-standardization strategy. In contrast, a differentiator is more likely to be successful in pursuing an international or multidomestic strategy. The same caveats raised concerning a blue ocean strategy at the business level apply at the corporate level: Although attractive on paper, a transnational strategy combining high pressures for cost reductions with high pressures for local responsiveness is difficult to implement because of inherent trade-offs.

Finally, a strategic leader must be aware of the fact that despite globalization and the emergence of the internet, firm geographic location has actually maintained its importance. Critical masses of world-class firms are clearly apparent in *regional geographic clusters*. Think of computer technology firms in Silicon Valley, medical device firms in the Chicago area, and biotechnology firms in and around Boston. This is a worldwide phenomenon. Known for their engineering prowess, car companies such as Daimler, BMW, Audi, and Porsche are clustered in southern Germany. Many fashion-related companies (clothing, shoes, and accessories) are located in northern Italy. Singapore is a well-known cluster for semiconductor materials, and India's leading IT firms are in Bangalore. Porter captures this phenomenon succinctly: "Paradoxically, the enduring competitive advantages in a global economy lie increasingly in local things—knowledge, relationships, and motivation that distant rivals cannot match."⁸³

This concludes our discussion of global strategy. Moreover, we have now completed our study of the first two pillars of the AFI framework—*strategy analysis* (Chapters 1 to 5) and *strategy formulation* (Chapters 6 to 10). Next, we turn to the third and final pillar of the AFI framework—*strategy implementation*. In Chapter 11, we'll study what managers can do to implement their carefully crafted strategies successfully and how to avoid failure. In Chapter 12, we study corporate governance and business ethics.

CHAPTERCASE 10 / Consider This. . .

DESPITE ITS TREMENDOUS success, IKEA faces significant challenges going forward. Opening new stores is critical to drive future growth (see Exhibit 10.1). Finding new sources of supply to support more store openings, however, is a challenge. Although demand for IKEA's low-cost home furnishings increased in the aftermath of the global financial crisis as more customers become price-conscious, IKEA's annual store growth has slowed in subsequent years. This is because its supply chain has become a bottleneck. IKEA has difficulty finding suppliers that are a strategic fit with its highly efficient operations. Related to this issue is the fact that wood remains one of IKEA's main input factors, and the world's consumers are becoming more sensitive to the issue of deforestation and its possible link to global warming. In the near future, IKEA must find low-cost replacement materials for wood.

Powerful competitors, moreover, have also taken notice of IKEA's success. Although IKEA is growing in North America, it holds less than 5 percent of the home-furnishings market. To keep IKEA at bay in the United States, Target has recently recruited top designers and launched a wide range of low-priced furnishings. In some European markets, IKEA holds 30 percent market share. IKEA has also been facing issues on the safety front and taken a hit to its corporate reputation. In 2016, IKEA was forced to recall 35 million chests and dressers in the United States and Canada, because they were implicated in the death of several toddlers. Covered widely in the media, the dressers tipped over easily and were not designed to be anchored in a wall. IKEA agreed to a \$50 million settlement.

Besides these external challenges, IKEA also faces significant internal ones. Since the company's founding in 1943, no strategic decisions have been made without Ingvar Kamprad's involvement and explicit approval. Kamprad (now in his 90s) in 2013 stepped down from chairing Inter IKEA, the foundation that owns the company. Many observers compare Kamprad's influence on IKEA's culture and organization to that of the legendary Sam Walton at Walmart. Kamprad's three sons are taking on stronger leadership roles at IKEA, including chairing the foundation that controls IKEA. In 2017, IKEA appointed Jesper Brodin, a former assistant to Ingvar Kamprad, as the new CEO.

With new leadership, IKEA is making a major push into online sales. Unlike its competition, IKEA had been slow to compete online, with its chief executive openly accepting that IKEA failed to realize that the internet was not just another

fad, but rather a significant disruptor for retailing. IKEA's store traffic and website visits are indicative of this strategic shift. While IKEA's website visits more than doubled within a five-

year period (to over 2 billion a year), in-person visits to IKEA stores increased a mere 3 percent a year (to about 1 billion in 2017).

IKEA also faces some limitations due to its complicated ownership structure. IKEA is privately held through a complex network of foundations and holding companies in the Netherlands, Liechtenstein, and Luxembourg. This arrangement provides benefits in terms of reducing tax exposure, but also creates significant constraints in accessing large sums of capital needed for rapid global expansion. In addition, many EU countries as well as the United States have become increasingly more sensitive to the issue of tax-avoidance schemes by large multinational enterprises.

IKEA will need to address the slew of internal and external challenges to achieve its strategic intent of doubling its number of yearly openings in an attempt to capture a larger slice of fast-growing markets, such as the United States, and to make stronger in-roads in newer markets like China and India. As more and more people are buying furniture online, IKEA now also has to contend with the likes of Amazon, Alibaba, and other online retailers specializing in home furnishings.



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Questions

1. List IKEA's external and internal challenges. Looking at IKEA's challenges, which ones do you think pose the greatest threat? Why? How would you address the challenges?
2. Ingvar Kamprad's influence over IKEA may have even been stronger than that of Sam Walton over Walmart because IKEA is a privately held company, whereas Walmart is a public company (since 1970). Walmart entered a period of difficulties after Sam Walton stepped down (in 1988 at age 70). Do you think IKEA had similar difficulties after it endured a similar leadership transition in 2013, when Ingvar Kamprad stepped down? Why or why not?

3. Did it surprise you to learn that both a rich developed country (e.g., the United States and Australia) as well as emerging economies (e.g., China and India) are the fastest-growing international markets for IKEA? Does this fact pose any challenges in the way IKEA ought to compete across the globe? Why or why not?
4. What can IKEA do to continue to drive growth globally, especially given its strategic intent to double annual store openings?
5. Assume you are hired to consult IKEA on the topic of *corporate social responsibility* (see the discussion in Chapter 2). Which areas would you recommend the company be most sensitive to, and how should these be addressed?

TAKE-AWAY CONCEPTS

This chapter discussed the roles of MNEs for economic growth; the stages of globalization; why, where, and how companies go global; four strategies MNEs use to navigate between cost reductions and local responsiveness; and national competitive advantage, as summarized by the following learning objectives and related take-away concepts.

LO 10-1 / Define *globalization*, *multinational enterprise (MNE)*, *foreign direct investment (FDI)*, and *global strategy*.

- Globalization involves closer integration and exchange between different countries and peoples worldwide, made possible by factors such as falling trade and investment barriers, advances in telecommunications, and reductions in transportation costs.
- A multinational enterprise (MNE) deploys resources and capabilities to procure, produce, and distribute goods and services in at least two countries.
- Many MNEs are more than 50 percent globalized; they receive the majority of their revenues from countries other than their home country.
- Product, service, and capital markets are more globalized than labor markets. The level of everyday activities is roughly 10 to 25 percent integrated, and thus *semi-globalized*.
- Foreign direct investment (FDI) denotes a firm's investments in value chain activities abroad.

LO 10-2 / Explain why companies compete abroad, and evaluate the advantages and disadvantages of going global.

- Firms expand beyond their domestic borders if they can increase their economic value creation ($V - C$) and enhance competitive advantage.

- Advantages to competing internationally include gaining access to a larger market, gaining access to low-cost input factors, and developing new competencies.
- Disadvantages to competing internationally include the liability of foreignness, the possible loss of reputation, and the possible loss of intellectual capital.

LO 10-3 / Apply the CAGE distance framework to guide MNE decisions on which countries to enter.

- Most of the costs and risks involved in expanding beyond the domestic market are created by *distance*.
- The CAGE distance framework determines the *relative* distance between home and foreign target country along four dimensions: cultural distance, administrative and political distance, geographic distance, and economic distance.

LO 10-4 / Compare and contrast the different options MNEs have to enter foreign markets.

- The strategist has the following foreign-entry modes available: exporting, strategic alliances (licensing for products, franchising for services), joint venture, and subsidiary (acquisition or greenfield).
- Higher levels of control, and thus a greater protection of IP and a lower likelihood of any loss in reputation, go along with more investment-intensive foreign-entry modes such as acquisitions or greenfield plants.

LO 10-5 / Apply the integration-responsiveness framework to evaluate the four different strategies MNEs can pursue when competing globally.

- To navigate between the competing pressures of cost reductions and local responsiveness, MNEs have four strategy options: international, multidomestic, global-standardization, and transnational.
- An international strategy leverages home-based core competencies into foreign markets, primarily through exports. It is useful when the MNE faces low pressures for both local responsiveness and cost reductions.
- A multidomestic strategy attempts to maximize local responsiveness in the face of low pressure for cost reductions. It is costly and inefficient because it requires the duplication of key business functions in multiple countries.
- A global-standardization strategy seeks to reap economies of scale and location by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. It involves little or no local responsiveness.
- A transnational strategy attempts to combine the high local responsiveness of a localization strategy with the lowest-cost position attainable from a global-standardization strategy. It also aims to benefit from global learning. Although appealing, it is difficult to implement due to the organizational complexities involved.

LO 10-6 / Apply Porter's diamond framework to explain why certain industries are more competitive in specific nations than in others.

- National competitive advantage, or world leadership in specific industries, is created rather than inherited.
- Four interrelated factors explain national competitive advantage: (1) factor conditions, (2) demand conditions, (3) competitive intensity in a focal industry, and (4) related and supporting industries/complementors.
- Even in a more globalized world, the basis for competitive advantage is often local.

KEY TERMS

CAGE distance framework (p. 353)

Cultural distance (p. 355)

Death-of-distance hypothesis (p. 362)

Foreign direct investment (FDI) (p. 342)

Global-standardization strategy (p. 360)

Global strategy (p. 342)

Globalization (p. 342)

Globalization hypothesis (p. 358)

Integration-responsiveness framework (p. 358)

International strategy (p. 359)

Liability of foreignness (p. 350)

Local responsiveness (p. 358)

Location economies (p. 349)

Multidomestic strategy (p. 360)

Multinational enterprise (MNE) (p. 342)

National competitive advantage (p. 363)

National culture (p. 354)

Transnational strategy (p. 361)

DISCUSSION QUESTIONS

1. Multinational enterprises (MNEs) have an impact far beyond their firm boundaries. Assume you are working for a small firm that supplies a product or service to an MNE. How might your relationship change as the MNE moves from Globalization 2.0 to Globalization 3.0 operations?
2. Professor Pankaj Ghemawat delivered a TED talk titled "Actually, the World Isn't Flat." Do you agree with his assessment that the world is at most *semi-globalized*, and that we need to be careful not to fall victim to "globalony"? View the talk at: www.ted.com/talks/pankaj_ghemawat_actually_the_world_isn_t_flat?language=en.
3. The chapter notes that global strategy can change over time for a firm. MTV is highlighted as one example in Exhibit 10.8. Conduct a web search of a firm you know to be operating internationally and determine its current global strategy position. How long has the firm stayed with this approach? Can you find evidence it had a different global strategy earlier?

ETHICAL/SOCIAL ISSUES

1. A race to the bottom may set in as MNEs search for ever-lower-cost locations. Discuss the trade-offs between the positive effects of raising the standard of living in some of the world's poorest countries with the drawbacks of moving jobs established in one country to another. Does your perspective change in light of several accidents in textile factories in Bangladesh, Cambodia, and elsewhere, where the cumulative death was over 1,000 workers? What responsibilities do MNEs have?
2. Will the Globalization 3.0 strategy persist through the 21st century? If not, what will Globalization 4.0 look like? Several American companies such as Apple and GE have realized that they miscalculated the full cost of managing far-flung production operations and are bringing production back to the United States. *Forbes* magazine put the blame on managers who were focused on maximizing shareholder value rather than emphasizing the long-term future of the firm.⁸⁴ That is, some managers looked only at labor costs and

ignored the hidden costs of time and money trying to communicate quality and design concerns to workers across countries as well as unexpected costs to the supply chain from natural disasters or political threats. These factors combined with the new economics of energy (e.g., growing supply of natural gas) and new technologies (robotics, artificial intelligence, 3-D printing, and nanotechnology) are rapidly changing manufacturing and management decisions.

Discuss the factors that managers of Apple or GE may consider as they focus on continuous innovation rather than the cost of manufacturing. How might governments with an interest in generating employment opportunities try to influence the decisions of firms? What other stakeholders may have an interest in bringing jobs back onshore and thus try to influence the decisions of firms? Consider the persuasive arguments and deals that might be struck. With changes to the location of production, what might Globalization 4.0 look like?

SMALL GROUP EXERCISES

//// SMALL GROUP EXERCISE 1

Many U.S. companies have become global players. The technology giant IBM employs over 375,000 people and has revenues of roughly \$95 billion. Although IBM is headquartered in Armonk, New York, the vast majority of its employees (more than 70 percent) actually work outside the United States. IBM, like many other U.S.-based multinationals, now earns the majority of its revenues (roughly two-thirds) outside the United States.⁸⁵ Though IBM revenues have been dropping in recent quarters, its global business is still a major focus for the firm.

1. Given that traditional U.S. firms such as IBM have over 70 percent of their employees outside the United States and earn almost two-thirds of their revenues from outside the country, what is an appropriate definition of a "U.S. firm"?

2. Should IKEA be considered a Swedish firm with less than 6 percent of sales garnered from the Swedish market? Discuss why or why not in your groups.
3. Is there any special consideration a firm should have for its "home country"? Is it ethical to keep profits outside the home country in offshore accounts to avoid paying domestic corporate taxes?

//// SMALL GROUP EXERCISE 2

In this exercise, we want to apply the four types of global strategy. Imagine your group works for Clif Bar (www.clifbar.com). Founded in 1992, the firm makes nutritious, all-natural food and drinks for sport and healthy snacking. Clif Bar is a privately held

company with some 400 employees. About 20 percent of the company is owned by the employees through an employee stock ownership plan (ESOP). The vast majority of Clif Bar's sales are in the United States. The firm has some distribution set up in Canada (since 1996) and the United Kingdom (since 2007). As of 2017, Clif Bar sells limited products in only 11 other countries: Australia, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, and New Zealand.

Review the company's website and news articles for more information about the firm and its products.

1. Apply the CAGE distance framework to the foreign countries where Clif Bar is operating. What is the *relative* distance of each to the United States? Rank the order of the countries in terms of *relative* distance.
2. Given the results from the CAGE model, do the chosen countries make sense? Why or why not?
3. Can you recommend three or four other countries Clif Bar should enter? Support your recommendations.
4. What entrance strategy should the firm employ in expanding the business to new countries? Why?

mySTRATEGY

How Do You Develop a Global Mind-set?

How can you develop the skills needed to succeed as an international leader? Researchers have developed a personal strategy for building a global mind-set that will facilitate success as an effective manager in a different cultural setting. A global mind-set has three components: *intellectual capital*, the understanding of how business works on a global level; *psychological capital*, openness to new ideas and experiences; and *social capital*, the ability to build connections with people and to influence stakeholders from a different cultural background.⁸⁶

- *Intellectual capital* is considered the easiest to gain if one puts forth the effort. You can gain global business acumen by taking courses, but you can learn a great deal on your own by reading publications with an international scope such as *The Economist*, visiting websites that provide information on different cultures or business operations in foreign countries, or simply watching television programs with an international news or culture focus. Working in global industries with people from diverse cultures is also a complex assignment, requiring the ability to manage complexity and uncertainty.
- *Psychological capital* is gained by being receptive to new ideas and experiences and appreciating diversity. It may be the most difficult to develop, because your ability to change your personality has limits. If you are enthusiastic about adventure and are willing to take risks in new environments, then you have the attitudes needed to be energized by a foreign assignment. It takes self-confidence and a sense of humor to adapt successfully to new environments.

- *Social capital* is based on relationships and is gained through experience. You can gain experience with diversity simply by widening your social circle, volunteering to work with international students, or by traveling on vacation or through a study abroad experience.

Now that you have a description of the three components of a global mind-set and a few ideas about how to develop the attributes necessary for global success, consider some ways you can develop a personal strategy that can be implemented during your college career.

1. So that you have a better idea of where you stand now, list your strengths and weaknesses for each component.
2. Identify your weakest area, and make a list of activities that will help you improve your capital in that area.
3. Identify courses you could take in international business, economics, politics, history, or art history. While you may be required to be proficient in at least one foreign language, learn a few words in other languages that can help you navigate any new countries you visit.
4. Make a list of at least six activities you could do this week to get started. For example, you could choose to work with international students on group projects in class. Or move on to having lunch with them. What questions could you ask that would help you learn about their culture and about doing business in their country? You could go to a museum with an exhibit from another culture, an international movie, or a restaurant with cuisine that is new to you.

If you are interested in more information, go to <https://thunderbird.asu.edu/faculty-and-research/najafi-global-mindset-institute>, where you can also take a sample survey to get an idea of the degree to which you have the attributes needed for global success.

ENDNOTES

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54. The *power-distance dimension* of national culture focuses on how a society deals with inequality among people in terms of physical and intellectual capabilities and how those methods translate into power distributions within organizations. High power-distance cultures, like the Philippines (94/100, with 100 = high), tend to allow inequalities among people to translate into inequalities in opportunity, power, status, and wealth. Low power-distance cultures, like Austria (11/100), on the other hand, tend to intervene to create a more equal distribution among people within organizations and society at large.
The *individualism dimension* of national culture focuses on the relationship between individuals in a society, particularly in regard to the relationship between individual and collective pursuits. In highly individualistic cultures, like the United States (91/100), individual freedom and achievements are highly valued. As a result, individuals are only tied loosely to one another within society. In less-individualistic cultures, like Venezuela (12/100), the collective good is emphasized over the individual, and members of society are strongly tied to one another throughout their lifetimes by virtue of birth into groups like extended families.
The *masculinity–femininity dimension* of national culture focuses on the relationship between genders and its relation to an individual's role at work and in society. In more "masculine" cultures, like Japan (95/100),

gender roles tend to be clearly defined and sharply differentiated. In “masculine” cultures, values like competitiveness, assertiveness, and exercise of power are considered cultural ideals, and men are expected to behave accordingly. In more “feminine” cultures, like Sweden (5/100), values like cooperation, humility, and harmony are guiding cultural principles. The masculinity–femininity dimension uncovered in Hofstede’s research is undoubtedly evolving over time, and values and behaviors are converging to some extent.

The *uncertainty-avoidance dimension* of national culture focuses on societal differences in tolerance toward ambiguity and uncertainty. In particular, it highlights the extent to which members of a certain culture feel anxious when faced with uncertain or unknown situations. Members of high uncertainty-avoidance cultures, like Russia (95/100), value clear rules and regulations as well as clearly structured career patterns, lifetime employment, and retirement benefits. Members of low uncertainty-avoidance cultures, like Singapore (8/100), have greater tolerance toward ambiguity and thus exhibit less emotional resistance to change and a greater willingness to take risks.

55. See: <http://geert-hofstede.com/nationalculture.html>. The available data, however, on the new dimensions are not, at this point, as comprehensive as for the four original dimensions. Alternatively, see the GLOBE cultural dimensions at www.groveswell.com/pub-GLOBE-intro.html.

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$$CD_j = \sum_{i=1}^4 \{ (I_{ij} - I_{iu})^2 / V_i \} / 4$$

where I_{ij} stands for the index for the i th cultural dimension and j th country, V_i is the variance of the index of i th dimension, u indicates the United States, and CD_j is the cultural distance difference of the j th country from the United States.

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PART

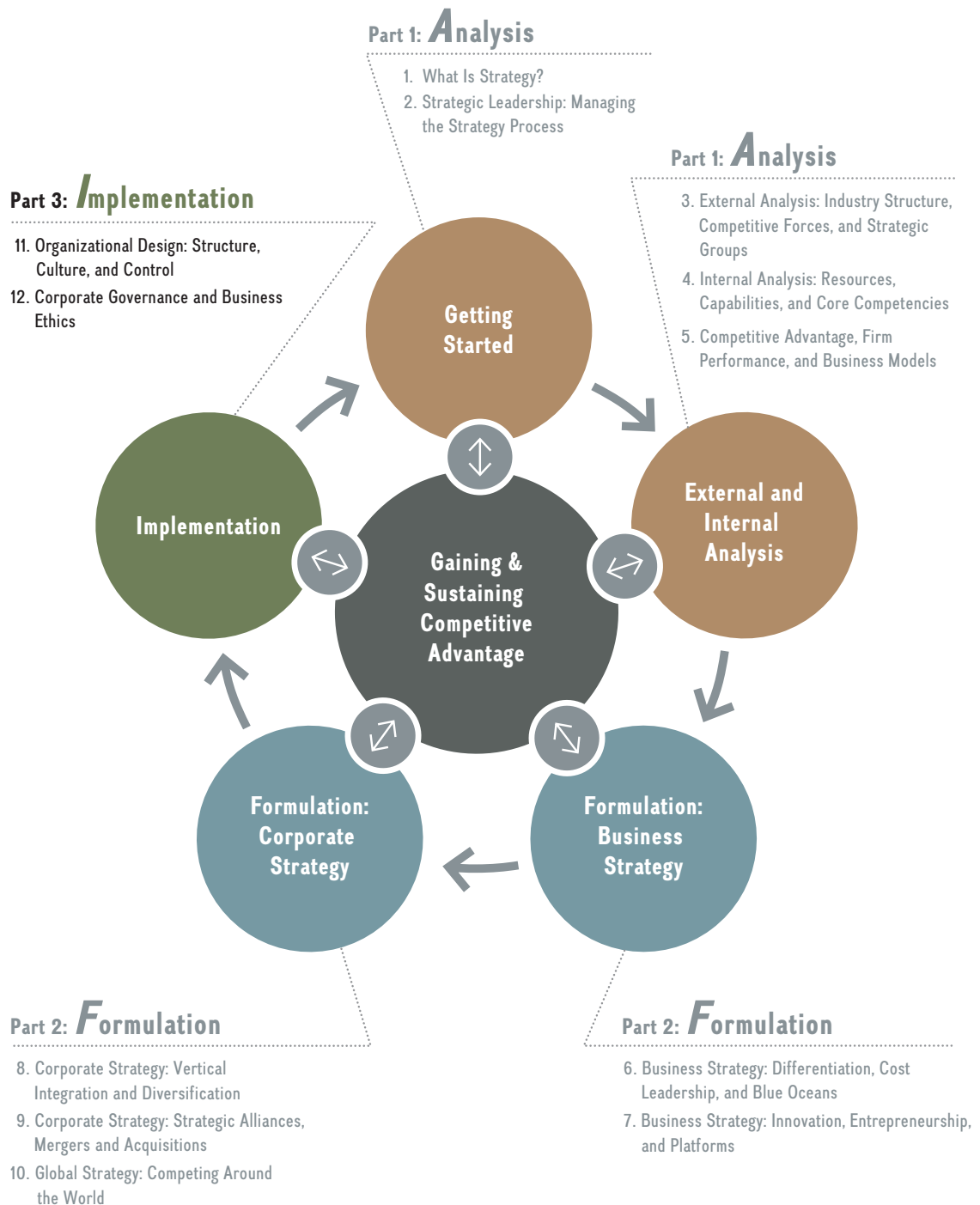
3

Implementation

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The AFI Strategy Framework



CHAPTER

11

Organizational Design: Structure, Culture, and Control

Chapter Outline

- 11.1 Organizational Design and Competitive Advantage**
Organizational Inertia: The Failure of Established Firms
Organizational Structure
Mechanistic vs. Organic Organizations
- 11.2 Strategy and Structure**
Simple Structure
Functional Structure
Multidivisional Structure
Matrix Structure
- 11.3 Organizing for Innovation**
- 11.4 Organizational Culture: Values, Norms, and Artifacts**
Where Do Organizational Cultures Come From?
How Does Organizational Culture Change?
Organizational Culture and Competitive Advantage
- 11.5 Strategic Control-and-Reward Systems**
Input Controls
Output Controls
- 11.6 Implications for Strategic Leaders**

Learning Objectives

- LO 11-1** Define organizational design and list its three components.
- LO 11-2** Explain how organizational inertia can lead established firms to failure.
- LO 11-3** Define organizational structure and describe its four elements.
- LO 11-4** Compare and contrast mechanistic versus organic organizations.
- LO 11-5** Describe different organizational structures and match them with appropriate strategies.
- LO 11-6** Evaluate closed and open innovation, and derive implications for organizational structure.
- LO 11-7** Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.
- LO 11-8** Compare and contrast different strategic control-and-reward systems.

Zappos: Of Happiness and Holacracy

ZAPPOS (www.zappos.com) made its mark delivering shoes and happiness. When Tony Hsieh (pronounced “Shay”), CEO of Zappos, wrote about the company’s unique approach in 2010’s *Delivering Happiness*, the book joined *The New York Times* bestseller list. Hsieh believes that making customers and employees happy drives success by “delivering WOW through service.” The result? The online shoe and clothing store grew from a startup to become a giant in the industry. Service includes easy online shopping with free shipping to and from its customers and a generous 365-day return policy.

Zappos also made its investors happy. In 2008, just 10 years after its founding, Zappos achieved more than \$1 billion in annual sales. In 2009, Amazon.com acquired the company for \$1.2 billion. Although now a subsidiary of Amazon, Zappos continues to operate as an independent brand, as Amazon maintains a hands-off policy.

If anything, new ideas flow up from Zappos to its parent. One example: Zappos weeds out cultural misfits by paying employees to leave after the orientation program. Amazon CEO Jeff Bezos said the “clever people at Zappos” inspired him to offer warehouse workers as much as \$5,000 to quit if they were not totally enthusiastic about the importance of their work to Amazon’s future.¹

Zappos has grown so much—receiving over 20 million unique visitors a month to its website—that it sometimes reorganizes to offer the best customer service possible. At one point, to keep the organization flat and responsive to customers, Zappos restructured into 10 separate business units including Zappos.com, Zappos Gift Cards, Zappos IP, and 6pm.com, among others. But in 2013, Hsieh announced a more radical approach to organization to fight the slow

bureaucracy that affects larger companies. That structure is called *holacracy*, which Hsieh explains as follows:

Research shows that every time the size of a city doubles, innovation or productivity per resident increases by 15 percent. But when companies get bigger, innovation or productivity per employee generally goes down. So we’re trying to figure out how to structure Zappos more like a city and less like a bureaucratic corporation. In a city, people and businesses are self-organizing. We’re trying to do the same thing by switching from a normal hierarchical structure to a system called Holacracy, which enables employees to act more like entrepreneurs and self-direct their work instead of reporting to a manager who tells them what to do.²



A flock of birds in flight, immediately shifting direction with self-regulating unity, frequently serves as a poetic symbol of holacracy in action.
©greatonmywall/Alamy Stock Photo

ing to a manager who tells them what to do.²

Here is what we know about holacracy. Often compared to a computer’s operating system, holacracy constitutes a new organizational structure for governing and running a company. Because it greatly changes how workers interact, pro-

ponents hail it as a “social technology.” Brian Robertson developed the concept in the 2000s, working from ideas introduced by Arthur Koestler in the 1967 book, *The Ghost in the Machine*, the work in which Koestler coined the term.³ Forgoing traditional top-down hierarchy, holacracy purports to achieve control and coordination by distributing power and authority to self-organizing groups (so-called circles) of employees. Circles of employees are meant to self-organize and self-govern around a specific task, such as confirming online orders or authorizing a customer’s credit card.

So Zappos grouped its over 1,500 employees in some 400 circles, with each employee in two or more circles. Order is supposed to emerge from the bottom up, rather than rely on top-down command and control. The rules are explicit in a so-called constitution, which defines the

power and authority of each circle. For coordination, the employee circles overlap horizontally, and without vertical hierarchy. The CEO's last act as the highest-ranking person in the organization is to sign the constitution in a symbolic act, relinquishing all executive powers. Thereafter the former leader becomes the "ratifier of the holacracy constitution."

Exhibit 11.1 provides an overview comparing a traditional organizational structure with holacracy.

As often happens, a new concept sounds great in theory, but proves hard to implement. In fact, Zappos is the first and only large corporation to try. (Robertson, the inventor of holacracy as an organizational form, ran a software company of 12 people where he tested his ideas.)⁴

You will learn more about Zappos by reading this chapter; related questions appear in "ChapterCase 11 / Consider This. . . ."

EXHIBIT 11.1 /

Traditional
Organizational
Structure vs.
Holacracy

SOURCE: Adapted from B. Robertson (2015), *Holacracy: The New Management System for a Rapidly Changing World* (New York: Henry Holt).

Traditional Organizational Structure	Holacracy
Static job description	Dynamic roles
Top-down	Self-organizing teams
Hierarchical decision making	Employee senses tension as dissonance between <i>what is</i> (current reality) and <i>what could be</i> (the purpose). How to resolve tension is worked out in circle meetings.
Formal authority	Distributed authority
Command and control	Employee autonomy
Functional areas	Employee circles
Alignment via politics	Transparent rules defined in constitution
Large-scale reorganizations	Rapid, fluid, and constant iterations

 **ZAPPOS CEO TONY HSIEH** believes that about one-half of all retail transactions in the United States will be online soon, and that people will buy from the company with the best customer service and best selection. His strategic intent for Zappos is to be that online store, to differentiate itself from the competition with superior service and selection. Hsieh remains unusually thoughtful about what type of structure, culture, and processes will advance that strategy. He initially designed Zappos as a flat organization to help Zappos provide exceptional service, and he continued to refine its organizational design through trial and error, with transparency, while nurturing a supportive culture by soliciting bottom-up feedback. And he celebrated the emphasis on happiness as noted in his book, with the understanding that happy employees are productive employees.

Yet, increased bureaucracy and a loss of productivity could not be avoided as the company grew and matured. To move Zappos forward, Hsieh proposed a new organizational structure called **holacracy**, a form of social technology that Hsieh believes will allow Zappos to pursue its purpose of delivering happiness and WOW through customer service.

This chapter opens the final part of the *AFI framework*: strategy implementation. *Strategy implementation* concerns the organization, coordination, and integration of how work gets done (see discussion in Chapter 2).

Effective strategy implementation is critical to gaining and sustaining competitive advantage. Although the discussion of *strategy formulation* (what to do) is distinct from *strategy implementation* (how to do it), formulation and implementation must be part of an interdependent, reciprocal process to ensure continued success. That need for

holacracy An organizational structure in which decision-making authority is distributed through loose collections or circles of self-organizing teams.

interdependence explains why the AFI framework is illustrated as a circle, rather than a linear diagram (see Part 3 Opener). The design of an organization, the matching of strategy and structure, and its control-and-reward systems determine whether or not an organization that has chosen an effective strategy will be able to gain and sustain a competitive advantage. As discussed in ChapterCase 11, Zappos pursues a differentiation strategy at the business level, which it is now implementing internally and structurally through holacracy. Whether Zappos' strategy implementation will be successful or not remains to be seen.

In this chapter, we study the three key levers that managers have at their disposal when designing their organizations for competitive advantage: *structure*, *culture*, and *control*. Managers employ these three levers to coordinate work and motivate employees across different levels, functions, and geographies. How successful they are in this endeavor determines whether they are able to translate their chosen business, corporate, and global strategy into strategic actions and business models, and ultimately whether the firm is able to gain and sustain a competitive advantage.

We begin our discussion with organizational structure. We discuss different types of organizational structures as well as why and how they need to change over time as successful firms grow in size and complexity. We highlight the critical need to match strategy and structure. We also present different ways to organize for innovation before taking a closer look at corporate culture. An organization's culture can either support or hinder its quest for competitive advantage.⁵ We next study strategic control systems, which allow managers to receive feedback on how well a firm's strategy is being implemented. We conclude our discussion of how to design an organization for competitive advantage with practical *Implications for Strategic Leaders*.

LO 11-1

Define organizational design and list its three components.

organizational design The process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization.

11.1 Organizational Design and Competitive Advantage

Organizational design is the process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization. The key components of organizational design are structure, culture, and control. The goal is to design an organization that allows managers to effectively translate their chosen strategy into a realized one.

Not surprisingly, the inability to implement strategy effectively is the number-one reason boards of directors fire CEOs.⁶ Yahoo's co-founder and CEO Jerry Yang was ousted in 2008 precisely because he failed to implement necessary strategic changes after Yahoo lost its competitive advantage.⁷ In the two years leading up to his exit, Yahoo lost more than 75 percent of its market value. Yang was described as someone who preferred consensus among his managers to making tough strategic decisions needed to change Yahoo's structure. That preference, though, led to bickering and infighting. Yang's failure to make the necessary changes to the internet firm's organizational structure led to a destruction of billions of dollars in shareholder value and thousands of layoffs. A number of short-term and interim CEOs followed Yang without much success. Then in 2012, Yahoo tapped former Google executive Marissa Mayer as president and CEO; Mayer's turnaround efforts focused on improving the user experience to drive mobile advertising revenues. Such a strategic reorientation required changes in the organizational structure and culture as well. Despite all these changes, Yahoo was not able to gain significant ground in the online



As CEO of Yahoo, Marissa Mayer attempted a turnaround of the struggling internet company by making changes to Yahoo's organizational structure and culture, among other strategic initiatives. In the end, a successful turnaround of the once-leading internet company remained elusive, and Verizon bought Yahoo for a mere \$4.5 billion in 2017.

©AP Images/Julie Jacobson

advertising space, which Google and Facebook continue to dominate. Once a leader in online search and valued at over \$200 billion (in 2001 at the height of the dot.com boom), Yahoo was acquired by Verizon for a mere \$4.5 billion in 2017.⁸

Because implementation transforms strategy into actions and business models, it often requires changes within the organization. However, strategy implementation often fails because managers are unable to make the necessary changes due to the effects on resource allocation and power distribution within an organization.⁹ Strategic leaders are leery about disturbing the status quo. As demonstrated by business historian Alfred Chandler in his seminal book *Strategy and Structure*, organizational structure must follow strategy in order for firms to achieve superior performance: “Structure can be defined as the design of organization through which the enterprise is administered . . . *structure follows strategy*.”¹⁰ This tenet implies that to implement a strategy successfully, organizational design must be flexible enough to accommodate the formulated strategy and future growth and expansion.

Featured in the ChapterCase, Zappos provides an example of a company with flexible organizational structure. When establishing customer service as a core competency, one of the hardest decisions Hsieh made early was to pull the plug on drop-shipment orders. These are orders for which Zappos would be the intermediary, relaying them to particular shoe vendors that then ship directly to the customer. Such orders were profitable because Zappos would not have to stock the shoes. They were also appealing because the fledgling startup was still losing money. But the problem was twofold. The vendors were slower than Zappos in filling orders. In addition, they did not accomplish the reliability metric that Zappos wanted for exceptional service: 95 percent accuracy was simply not good enough! Instead, Zappos decided to forgo drop shipments and instead built a larger warehouse in Kentucky to stock a full inventory. This move enabled the firm to achieve close to 100 percent accuracy in its shipments, many of which were overnight. Unlike other online retailers, Zappos stocks everything it sells in its own warehouses—this is the only way to get the merchandise as quickly as possible with 100 percent accuracy to the customer. Strategy, therefore, is as much about deciding what to do as it is about deciding what *not* to do.

LO 11-2

Explain how organizational inertia can lead established firms to failure.

inertia A firm's resistance to change the status quo, which can set the stage for the firm's subsequent failure.

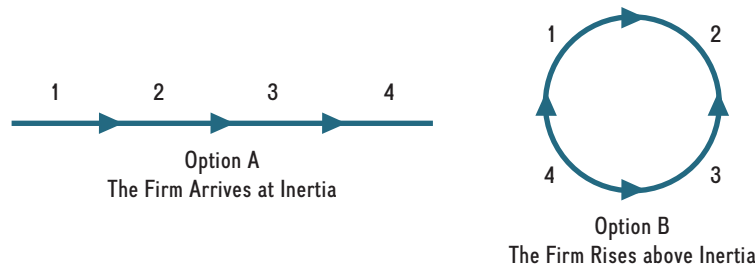
ORGANIZATIONAL INERTIA: THE FAILURE OF ESTABLISHED FIRMS

To implement a formulated business strategy successfully, structure must accommodate strategy, not the other way around. In reality, however, a firm's strategy often follows its structure.¹¹ This reversal implies that some managers consider only strategies that do not change existing organizational structures; they do not want to confront the inertia that often exists in established organizations.¹² **Inertia**, a firm's resistance to change the status quo, can set the stage for the firm's subsequent failure. Successful firms often plant the seed of subsequent failure: They optimize their organizational structure to the current situation. That tightly coupled system can break apart when internal or external pressures occur.

Note that organizational inertia is often the result of success in a particular market during a particular time; it becomes difficult to argue with success. The pattern for successful firms often follows a particular path:

1. Mastery of, and fit with, the current environment.
2. Success, usually measured by financial measurements.
3. Structures, measures, and systems to accommodate and manage size.
4. A resulting organizational inertia that tends to minimize opportunities and challenges created by shifts in the internal and external environment.

What's missing, of course, is the conscious strategic decision to change the firm's internal environment to fit with the new external environment, turning four steps leading to the endpoint of inertia (Option A) into the kind of a virtual circle where the firm essentially reboots and reinvents itself (Option B).



Consider that the need for structural reorganization can be especially intense in many industries where the rate of change is high and potential disruption frequent. Consider also that business leaders find it much easier to create and manage within developed structures than to restructure their organizations to be where they will need to be in future.

Exhibit 11.2 shows how success in the current environment can lead to a firm's downfall in the future, when the tightly coupled system of strategy and structure experiences internal or external shifts.¹³ First, the managers achieve a mastery of, and fit with, the firm's current environment. Second, the firm often defines and measures success by financial metrics, with a focus on short-term performance (see discussion in Chapter 5). Third, the firm puts in place structures, metrics, and systems to accommodate and manage increasing

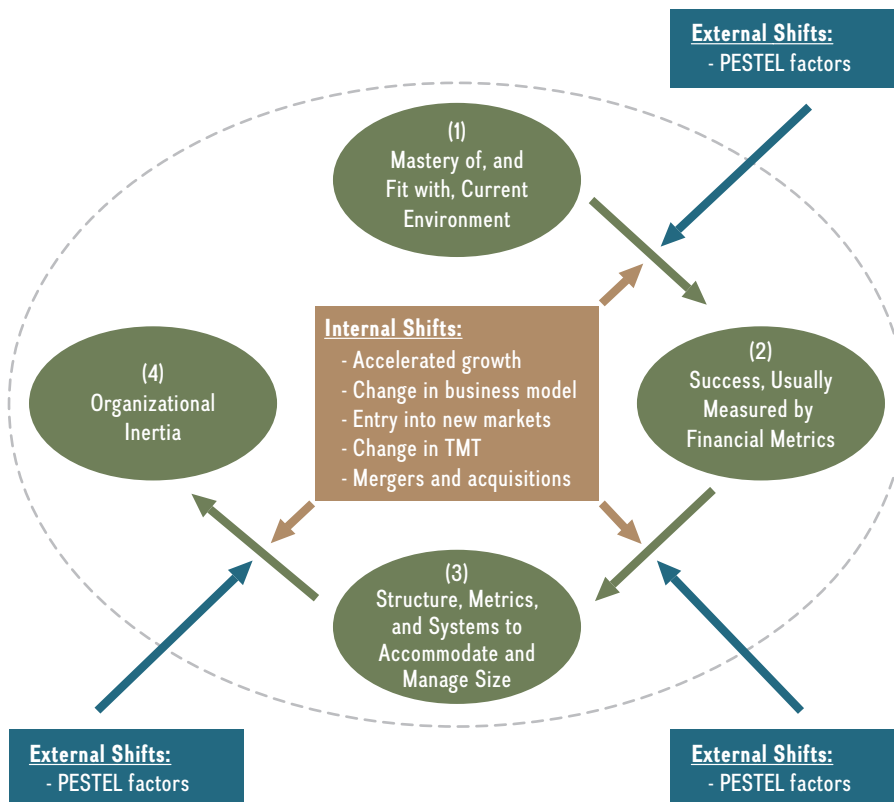


EXHIBIT 11.2 / Organizational Inertia and the Failure of Established Firms to Respond to Shifts in the External or Internal Environments

firm size and complexity due to continued success. Finally, as a result of a tightly coupled albeit successful system, organizational inertia sets in—and with it, resistance to change.

Such a tightly coupled system is prone to break apart when external and internal shifts put pressure on the system.¹⁴ In Exhibit 11.2, inside the oval, the longer internal arrows show the firm's tightly coupled organizational design over time. The shorter internal arrows indicate pressures radiating from internal shifts such as accelerated growth, a change in the business model, entry into new markets, a change in the top management team (TMT), or mergers and acquisitions. Accelerated growth, for example, was the reason for a decline in employee productivity at Zappos, as discussed in the ChapterCase. The longest arrows pointing into and piercing the boundary of the firm indicate external pressures, which can stem from any of the PESTEL forces (political, economic, sociocultural, technological, ecological, and legal, as discussed in Chapter 3). Strong external or internal pressure can break apart the current system, which may lead to firm failure. To avoid inertia and possible organizational failure, the firm needs a flexible and adaptive structure to effectively translate the formulated strategy into action. Ideally the firm would maintain a virtuous cycle of reconsidering organization, as implied by Option B earlier in the chapter. Tony Hsieh hopes that holacracy will help Zappos to rise above inertia and to reorganize in a more flexible and responsive fashion.

LO 11-3

Define organizational structure and describe its four elements.

organizational structure A key to determining how the work efforts of individuals and teams are orchestrated and how resources are distributed.

specialization An organizational element that describes the degree to which a task is divided into separate jobs (i.e., the division of labor).

formalization An organizational element that captures the extent to which employee behavior is steered by explicit and codified rules and procedures.

ORGANIZATIONAL STRUCTURE

Some of the key decisions managers must make when designing effective organizations pertain to the firm's **organizational structure**. That structure determines how the work efforts of individuals and teams are orchestrated and how resources are distributed. In particular, an organizational structure defines how jobs and tasks are divided and integrated, delineates the reporting relationships up and down the hierarchy, defines formal communication channels, and prescribes how individuals and teams coordinate their work efforts. The key building blocks of an organizational structure are:

- Specialization
- Formalization
- Centralization
- Hierarchy

SPECIALIZATION. **Specialization** describes the degree to which a task is divided into separate jobs—that is, the *division of labor*. Larger firms, such as Fortune 100 companies, tend to have a high degree of specialization; smaller entrepreneurial ventures tend to have a low degree of specialization. For example, an accountant for a large firm may specialize in only one area (e.g., internal audit), whereas an accountant in a small firm needs to be more of a generalist and take on many different things (e.g., internal auditing, plus payroll, accounts receivable, financial planning, and taxes). Specialization requires a trade-off between breadth and depth of knowledge. While a high degree of the division of labor increases productivity, it can also have unintended side-effects such as reduced employee job satisfaction due to repetition of tasks.

FORMALIZATION. **Formalization** captures the extent to which employee behavior is steered by explicit and codified rules and procedures. Formalized structures are characterized by detailed written rules and policies of what to do in specific situations. These are often codified in employee handbooks. McDonald's, for example, uses detailed standard operating procedures throughout the world to ensure consistent quality and service.

Formalization, therefore, is not necessarily negative; often it is necessary to achieve consistent and predictable results. Airlines, for instance, must rely on a high degree of formalization to instruct pilots on how to fly their airplanes to ensure safety and reliability. Yet a high degree

of formalization can slow decision making, reduce creativity and innovation, and hinder customer service.¹⁵ Most customer service reps in call centers, for example, follow a detailed script. This is especially true when call centers are outsourced to overseas locations. Zappos deliberately avoided this approach when it made customer service its core competency.

CENTRALIZATION. **Centralization** refers to the degree to which decision making is concentrated at the top of the organization. Centralized decision making often correlates with slow response time and reduced customer satisfaction. In decentralized organizations such as Zappos, decisions are made and problems solved by empowered lower-level employees who are closer to the source of issues.

Different strategic management processes (discussed in Chapter 2) match with different degrees of centralization:

- Top-down strategic planning takes place in highly centralized organizations.
- Planned emergence is found in more decentralized organizations.

Whether centralization or decentralization is more effective depends on the specific situation. During the Gulf of Mexico oil spill in 2010, BP's response was slow and cumbersome because key decisions were initially made in its UK headquarters and not onsite. In this case, centralization reduced response time and led to a prolonged crisis. In contrast, the FBI and the CIA were faulted in the 9/11 Commission report for *not being centralized enough*.¹⁶ The report concluded that although each agency had different types of evidence that a terrorist strike in the United States was imminent, their decentralization made them unable to put together the pieces to prevent the 9/11 attacks.

HIERARCHY. **Hierarchy** determines the formal, position-based reporting lines and thus stipulates *who reports to whom*. Let's assume two firms of roughly equal size: Firm A and Firm B. If many levels of hierarchy exist between the frontline employee and the CEO in Firm A, it has a *tall structure*. In contrast, if there are few levels of hierarchy in Firm B, it has a *flat structure*.

The number of levels of hierarchy, in turn, determines the managers' **span of control**—how many employees directly report to a manager. In tall organizational structures (Firm A), the span of control is narrow. In flat structures (Firm B), the span of control is wide, meaning one manager supervises many employees. In recent years, firms have de-layered by reducing the headcount (often middle managers), making the organizations flatter and more nimble. This, however, puts more pressure on the remaining managers who have to supervise and monitor more direct reports due to an increased span of control.¹⁷ Recent research suggests that managers are most effective at an intermediate point where the span of control is not too narrow or too wide.¹⁸

MECHANISTIC VS. ORGANIC ORGANIZATIONS

Several of the building blocks of organizational structure frequently appear together, creating distinct organizational forms—mechanistic or organic organizations.¹⁹

MECHANISTIC ORGANIZATIONS. **Mechanistic organizations** are characterized by a high degree of specialization and formalization and by a tall hierarchy that relies on centralized decision making. The fast food chain McDonald's fits this description quite well. Each step of every job such as deep-frying fries is documented in minute detail (e.g., what kind of vat, the quantity of oil, how many fries, what temperature, how long, and so on). Decision power is centralized at the top of the organization: McDonald's headquarters provides detailed instructions to each of its franchisees so that they provide comparable quality and service across the board although with some local menu variations.

centralization An organizational element that refers to the degree to which decision making is concentrated at the top of the organization.

hierarchy An organizational element that determines the formal, position-based reporting lines and thus stipulates who reports to whom.

span of control The number of employees who directly report to a manager.

mechanistic organization. Characterized by a high degree of specialization and formalization and by a tall hierarchy that relies on centralized decision making.

LO 11-4

Compare and contrast mechanistic versus organic organizations.

Strategy Highlight 11.1

W.L. Gore & Associates: Informality and Innovation

W.L. Gore & Associates is the inventor of path-breaking new products such as breathable GORE-TEX fabrics, Glide dental floss, and Elixir guitar strings. Bill Gore, a former longtime employee of chemical giant DuPont, founded the company with the vision to create an organization “devoted to innovation, a company where imagination and initiative would flourish, where chronically curious engineers would be free to invent, invest, and succeed.”²⁰ When founding the company in 1958, Gore articulated four core values that still guide the company and its associates to this day:

1. Fairness to each other and everyone with whom the firm does business.
2. Freedom to encourage, help, and allow other associates to grow in knowledge, skill, and scope of responsibility.
3. The ability to make one’s own commitments and keep them.
4. Consultation with other associates before undertaking actions that could cause serious damage to the reputation of the company (“blowing a hole below the waterline”).

W.L. Gore & Associates is organized in an informal and decentralized manner: It has no formal job titles, job descriptions, chains of command, formal communication channels, written rules or standard operating procedures. Face-to-face

communication is preferred over e-mail. There is no organizational chart. In what is called a *lattice* or *boundaryless* organizational form, everyone is empowered and encouraged to speak to anyone else in the organization. People who work at Gore are called *associates* rather than *employees*, indicating professional expertise and status. Gore associates organize themselves in project-based teams that are led by sponsors, not bosses. Associates invite other team members based on their expertise and interests in a more or less ad hoc fashion. Peer control in these multidisciplinary teams further enhances associate productivity. Group members evaluate each other’s performance annually, and these evaluations determine each associate’s level of compensation. Moreover, all associates at W.L. Gore are also shareholders of the company, and thus are part owners sharing in profits and losses.

Gore’s freewheeling and informal culture has been linked to greater employee satisfaction and retention, higher personal initiative and creativity, and innovation at the firm level. Although W.L. Gore’s organizational structure may look like something you might find in a small, high-tech startup, the company has 10,000 employees and over \$3 billion in revenues, making Gore one of the largest privately held companies in the United States. W.L. Gore is consistently ranked in *Fortune*’s “100 Best Companies to Work For” list, and has been included in every edition of that prestigious ranking.²¹

Communication and authority lines are top-down and well defined. To ensure standardized operating procedures and consistent food quality throughout the world, McDonald’s operates Hamburger University, a state-of-the-art teaching facility in a Chicago suburb, where 50 full-time instructors teach courses in chemistry, food preparation, and marketing. In 2010, McDonald’s opened a second Hamburger University campus in Shanghai, China. Mechanistic structures allow for standardization and economies of scale, and often are used when the firm pursues a cost-leadership strategy at the business level.

organic organization
Characterized by a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making.

ORGANIC ORGANIZATIONS. Organic organizations have a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making. Organic structures tend to be correlated with the following: a fluid and flexible information flow among employees in both horizontal and vertical directions; faster decision making; and higher employee motivation, retention, satisfaction, and creativity. Organic organizations also typically exhibit a higher rate of entrepreneurial behaviors and innovation. Organic structures allow firms to foster R&D and/or marketing, for example, as a core competency. Firms that pursue a differentiation strategy at the business level frequently have an organic structure.

Strategy Highlight 11.1 shows how W.L. Gore & Associates uses an organic structure to foster continuous innovation.

EXHIBIT 11.3 / Mechanistic vs. Organic Organizations: Building Blocks of Organizational Structure

	Mechanistic Organizations	Organic Organizations
<i>Specialization</i>	• High degree of specialization • Rigid division of labor • Employees focus on narrowly defined tasks	• Low degree of specialization • Flexible division of labor • Employees focus on “bigger picture”
<i>Formalization</i>	• Intimate familiarity with rules, policies, and processes necessary • Deep expertise in narrowly defined domain required • Task-specific knowledge valued	• Clear understanding of organization's core competencies and strategic intent • Domain expertise in different areas • Generalized knowledge of how to accomplish strategic goals valued
<i>Centralization</i>	• Decision power centralized at top • Vertical (top-down) communication	• Distributed decision making • Vertical (top-down and bottom-up) as well as horizontal communication
<i>Hierarchy</i>	• Tall structures • Low span of control • Clear lines of authority • Command and control	• Flat structures • High span of control • Horizontal as well as two-way vertical communication • Mutual adjustment
<i>Business Strategy</i>	• Cost-leadership strategy • Examples: McDonald's; Walmart	• Differentiation strategy • Examples: W.L. Gore, Zappos

Exhibit 11.3 summarizes the key features of mechanistic and organic structures.

Although at first glance organic organizations may appear to be more attractive than mechanistic ones, their relative effectiveness depends on context. McDonald's, with its some 37,000 restaurants across the globe, would not be successful with an organic structure. Similarly, a mechanistic structure would not allow Zappos or W.L. Gore to develop and hone their respective core competencies in customer service and product innovation.

The key point is this: To gain and sustain competitive advantage, structure must follow strategy. Moreover, the chosen organizational form must match the firm's business strategy. We will expand further on the required strategy–structure relationship in the next section.

11.2 Strategy and Structure

The important and interdependent relationship between strategy and structure directly impacts a firm's performance. Moreover, the relationship is dynamic—changing over time in a somewhat predictable pattern as firms grow in size and complexity. Successful new ventures generally grow first by increasing sales, then by obtaining larger geographic reach, and finally by diversifying through vertical integration and entering into related and unrelated businesses.²² Different stages in a firm's growth require different organizational structures. This important evolutionary pattern is depicted in Exhibit 11.4. As we discuss next, organizational structures range from simple to functional to multidivisional to matrix.

SIMPLE STRUCTURE

A **simple structure** generally is used by small firms with low organizational complexity. In such firms, the founders tend to make all the important strategic decisions and run

LO 11-5

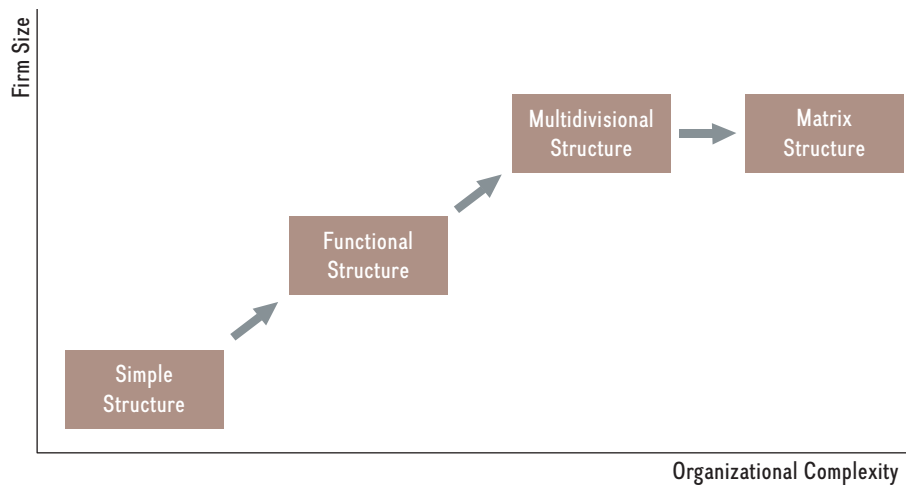
Describe different organizational structures and match them with appropriate strategies.

simple structure

Organizational structure in which the founders tend to make all the important strategic decisions as well as run the day-to-day operations.

EXHIBIT 11.4 /

Changing Organizational Structures and Increasing Complexity as Firms Grow



the day-to-day operations. Examples include entrepreneurial ventures such as Facebook in 2004, when the startup operated out of Mark Zuckerberg's dorm room, and professional service firms such as smaller advertising, consulting, accounting, and law firms, as well as family-owned businesses. Simple structures are flat hierarchies operated in a decentralized fashion. They exhibit a low degree of formalization and specialization. Typically, neither professional managers nor sophisticated systems are in place, which often leads to an overload for the founder and/or CEO when the firms experience growth.

FUNCTIONAL STRUCTURE

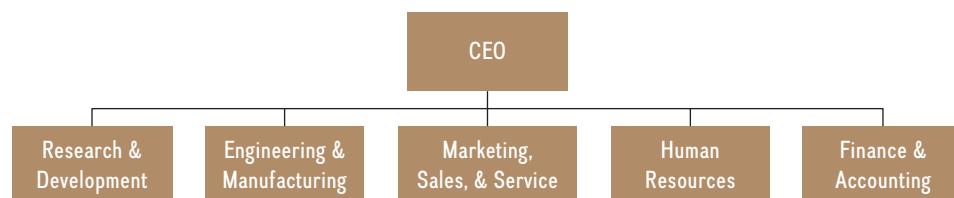
functional structure
Organizational structure that groups employees into distinct functional areas based on domain expertise.

As sales increase, firms generally adopt a **functional structure**, which groups employees into distinct functional areas based on domain expertise. These functional areas often correspond to distinct stages in the value chain such as R&D, engineering and manufacturing, and marketing and sales, as well as supporting areas such as human resources, finance, and accounting. Exhibit 11.5 shows a functional structure, with the lines indicating reporting and authority relationships. The department head of each functional area reports to the CEO, who coordinates and integrates the work of each function. A business school student generally majors in one of these functional areas such as finance, accounting, IT, marketing, operations, or human resources, and is then recruited into a corresponding functional group.

W.L. Gore began as a company by operating out of Bill Gore's basement and using a simple structure. Two years after its founding, the company received a large manufacturing order for high-tech cable that it could not meet with its ad hoc basement operation. At that point, W.L. Gore reorganized itself into a functional structure. A simple structure could not provide the effective division, coordination, and integration of work required to accommodate future growth.

EXHIBIT 11.5 /

Typical Functional Structure



A functional structure allows for a higher degree of specialization and deeper domain expertise than a simple structure. Higher specialization also allows for a greater division of labor, which is linked to higher productivity.²³ While work in a functional structure tends to be specialized, it is centrally coordinated by the CEO (see Exhibit 11.5). A functional structure allows for an efficient top-down and bottom-up communication chain between the CEO and the functional departments, and thus relies on a relatively flat structure.

FUNCTIONAL STRUCTURE AND BUSINESS STRATEGY. A functional structure is recommended when a firm has a fairly narrow focus in terms of product/service offerings (i.e., low level of diversification) combined with a small geographic footprint. It matches well, therefore, with the different *business* strategies discussed in Chapter 6: cost leadership, differentiation, and blue ocean. Although a functional structure is the preferred method for implementing business strategy, different variations and contexts require careful modifications in each case:

- The goal of a *cost-leadership strategy* is to create a competitive advantage by reducing the firm's cost below that of competitors while offering acceptable value. The cost leader sells a no-frills, standardized product or service to the mainstream customer. To effectively implement a cost-leadership strategy, therefore, managers must create a functional structure that contains the organizational elements of a *mechanistic structure*—one that is centralized, with well-defined lines of authority up and down the hierarchy. Using a functional structure allows the cost leader to nurture and constantly upgrade necessary core competencies in manufacturing and logistics. Moreover, the cost leader needs to create incentives to foster process innovation in order to drive down cost. Finally, because the firm services the average customer, and thus targets the largest market segment possible, it should focus on leveraging economies of scale to further drive down costs.
- The goal of a *differentiation strategy* is to create a competitive advantage by offering products or services at a higher perceived value, while controlling costs. The differentiator, therefore, sells a non-standardized product or service to specific market segments in which customers are willing to pay a higher price. To effectively implement a differentiation strategy, managers rely on a functional structure that resembles an *organic organization*. In particular, decision making tends to be decentralized to foster and incentivize continuous innovation and creativity as well as flexibility and mutual adjustment across areas. Using a functional structure with an organic organization allows the differentiator to nurture and constantly upgrade necessary core competencies in R&D, innovation, and marketing. Finally, the functional structure should be set up to allow the firm to reap economies of scope from its core competencies, such as by leveraging its brand name across different products or its technology across different devices.
- A successful *blue ocean strategy* requires reconciliation of the trade-offs between differentiation and low cost. To effectively implement a blue ocean strategy, the firm must be both efficient and flexible. It must balance centralization to control costs with decentralization to foster creativity and innovation. Managers must, therefore, attempt to combine the advantages of the functional-structure variations used for cost leadership and differentiation while mitigating their disadvantages. Moreover, the firm pursuing a blue ocean strategy needs to develop several distinct core competencies to both drive up perceived value and lower cost. It must further pursue both product and process innovations in an attempt to reap economies of scale and scope. All of these challenges make it clear that although a blue ocean strategy is attractive at first glance, it is quite difficult to implement given the range of important trade-offs that must be addressed.

A firm's structure is therefore critical when pursuing a blue ocean strategy. The challenge that managers face is to structure their organizations so that they control cost *and* allow for creativity that can lay the basis for differentiation. Doing both is hard. Achieving a low-cost position requires an organizational structure that relies on strict budget controls, while differentiation requires an organizational structure that allows creativity and customer responsiveness to thrive, which typically necessitates looser organizational structures and controls.

ambidextrous organization An organization able to balance and harness different activities in trade-off situations.

ambidexterity A firm's ability to address trade-offs not only at one point but also over time. It encourages managers to balance *exploitation* with *exploration*.

exploitation Applying current knowledge to enhance firm performance in the short term.

exploration Searching for new knowledge that may enhance a firm's future performance.

The goal for managers who want to pursue a blue ocean strategy is to build an **ambidextrous organization**, one that enables managers to balance and harness different activities in trade-off situations.²⁴ Here, the trade-offs to be addressed involve the simultaneous pursuit of low-cost and differentiation strategies. Notable management practices that companies use to resolve this trade-off include flexible and lean manufacturing systems, total quality management, just-in-time inventory management, and Six Sigma.²⁵ Other management techniques that allow firms to reconcile cost and value pressures are the use of teams in the production process, as well as decentralized decision making at the level of the individual customer.

Ambidexterity describes a firm's ability to address trade-offs not only at one point but also over time. It encourages managers to balance **exploitation**—applying current knowledge to enhance firm performance in the short term—with **exploration**—searching for new knowledge that may enhance a firm's future performance.²⁶ For example, while Intel focuses on maximizing sales from its *current* cutting-edge microprocessors, it also has several different teams with different time horizons working on *future* generations of microprocessors.²⁷ In ambidextrous organizations, managers must constantly analyze their existing business processes and routines, looking for ways to change them in order to resolve trade-offs across internal value chain activities and time.²⁸

Exhibit 11.6 presents a detailed match between different business strategies and their corresponding functional structures.

DISADVANTAGES OF FUNCTIONAL STRUCTURE. While certainly attractive, the functional structure is not without significant drawbacks. Although the functional structure facilitates rich and extensive communication between members of the *same* department, it frequently lacks effective communication channels *across* departments. Notice in Exhibit 11.5 the lack of links between different functions. The lack of linkage between functions is the reason, for example, why R&D managers often do not communicate directly with marketing managers. In an ambidextrous organization, a top-level manager such as the CEO must take on the necessary coordination and integration work.

To overcome the lack of cross-departmental collaboration in a functional structure, a firm can set up *cross-functional teams*. In these temporary teams, members come from different functional areas to work together on a specific project or product, usually from start to completion. Each team member reports to two supervisors: the team leader and the respective functional department head. As we saw in Strategy Highlight 11.1, W.L. Gore employs cross-functional teams successfully.

A second critical drawback of the functional structure is that it cannot effectively address a higher level of diversification, which often stems from further growth.²⁹ This is the stage at which firms find it effective to evolve and adopt a multidivisional or matrix structure, both of which we will discuss next.

MULTIDIVISIONAL STRUCTURE

Over time, as a firm diversifies into different product lines and geographies, it generally implements a multidivisional or a matrix structure (as shown in Exhibit 11.4).

EXHIBIT 11.6 /

Matching Business Strategy and Structure

Business Strategy	Structure
Cost-leadership	Functional • Mechanistic organization • Centralized • Command and control • Core competencies in efficient manufacturing and logistics • Process innovation to drive down cost • Focus on economies of scale
Differentiation	Functional • Organic organization • Decentralized • Flexibility and mutual adjustment • Core competencies in R&D, innovation, and marketing • Product innovation • Focus on economies of scope
Blue ocean	Functional • Ambidextrous organization • Balancing centralization with decentralization • Multiple core competencies along the value chain required: R&D, manufacturing, logistics, marketing, etc. • Process and product innovations • Focus on economies of scale and scope

The **multidivisional structure** (or **M-form**) consists of several distinct strategic business units (SBUs), each with its own profit-and-loss (P&L) responsibility. Each SBU is operated more or less independently from one another, and each is led by a CEO (or equivalent general manager) who is responsible for the unit's business strategy and its day-to-day operations. The CEOs of each division report to the corporate office, which is led by the company's highest-ranking executive (titles vary and include president or CEO for the entire corporation). Because most large firms are diversified to some extent across different product lines and geographies, the M-form is a widely adopted organizational structure.

Consider that Zappos is an SBU under Amazon, which employs a multidivisional structure. Also, W.L. Gore uses a multidivisional structure to administer its differentiation and related diversification strategies. It has four product divisions (electronic products, industrial products, medical products, and fabrics division) with manufacturing facilities in the United States, China, Germany, Japan, and Scotland, and business activities in 30 countries across the globe.³⁰

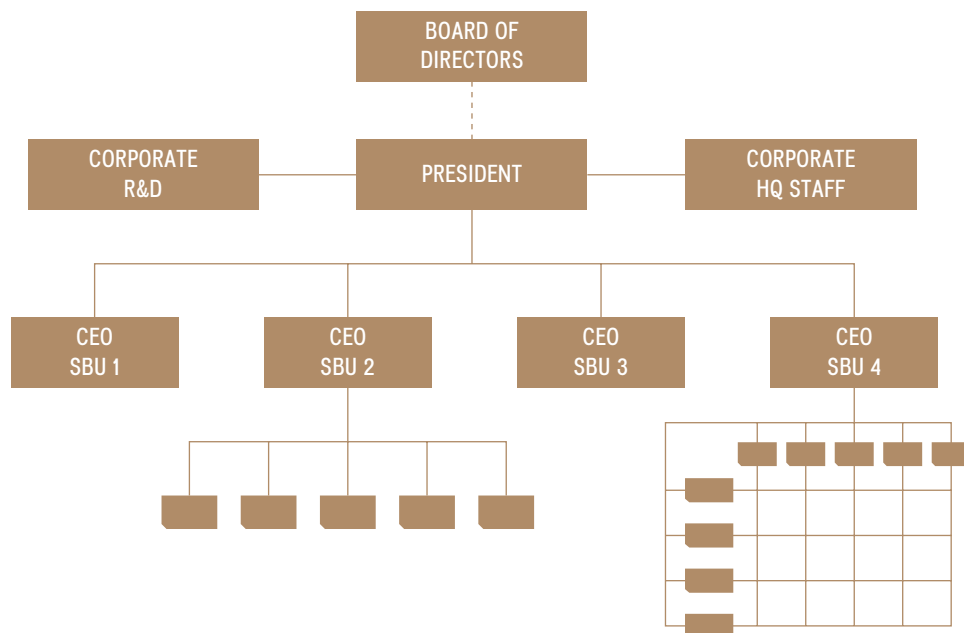
A typical M-form is shown in Exhibit 11.7. In this example, the company has four SBUs, each led by a CEO. Corporations may use SBUs to organize around different businesses and product lines or around different geographic regions. Each SBU represents a self-contained business with its own hierarchy and organizational structure. Note that in Exhibit 11.7, SBU 2 is organized using a functional structure, while SBU 4 is organized using a matrix structure. The CEO of each SBU must determine which organizational structure is most appropriate to implement the SBU's business strategy.

multidivisional structure (M-form)
Organizational structure that consists of several distinct strategic business units (SBUs), each with its own profit-and-loss (P&L) responsibility.

EXHIBIT 11.7 /

Typical Multidivisional (M-Form) Structure

Note that SBU 2 uses a functional structure, and SBU 4 uses a matrix structure.



A firm's corporate office is supported by company-wide staff functions such as human resources, finance, and corporate R&D. These staff functions support all of the company's SBUs, but are centralized at corporate headquarters to benefit from economies of scale and to avoid duplication within each SBU. Since most of the larger enterprises are publicly held stock companies, the president reports to a board of directors who represents the interests of the shareholders, indicated by the dashed line in Exhibit 11.7.

The president, with support from corporate headquarters staff, monitors the performance of each SBU and determines how to allocate resources across units.³¹ Corporate headquarters adds value by functioning as an internal capital market. The goal is to be more efficient at allocating capital through its budgeting process than what could be achieved in external capital markets. This can be especially effective if the corporation overall can access capital at a lower cost than competitors due to a favorable (AAA) debt rating. Corporate headquarters can also add value through restructuring the company's portfolio of SBUs by selling low-performing businesses and adding promising businesses through acquisitions.

M-FORM AND CORPORATE STRATEGY. To achieve an optimal match between strategy and structure, different corporate strategies require different organizational structures. In Chapter 8, we identified four types of corporate diversification (see Exhibit 8.8: *single business*, *dominant business*, *related diversification*, and *unrelated diversification*). Each is defined by the percentage of revenues obtained from the firm's primary activity.

- Firms that follow a single-business or *dominant-business strategy* at the corporate level gain at least 70 percent of their revenues from their primary activity; they generally employ a *functional structure*.
- For firms that pursue either *related* or *unrelated diversification*, the *M-form* is the preferred organizational structure.
- Firms using the M-form organizational structure to support a *related-diversification* strategy tend to concentrate decision making at the top of the organization. Doing so

allows a high level of integration. It also helps corporate headquarters leverage and transfer across different SBUs the core competencies that form the basis for a related diversification.

- Firms using the M-form structure to support an *unrelated-diversification* strategy often decentralize decision making. Doing so allows general managers to respond to specific circumstances, and leads to a low level of integration at corporate headquarters.

Exhibit 11.8 matches different corporate strategies and their corresponding organizational structures.

In this understanding we can see how Google was attempting to leverage unrelated diversification and its advantages (decentralized decision making) when it announced its reorganization in 2015.³² Google split itself and created a diversified multidivisional structure overseen by Alphabet, a new corporate entity. (For a visual of this structure, see Exhibit MC10.1 in MiniCase 10.) As Google had become much more complex over the years with a number of unrelated lines of businesses (think online search and longevity research), it moved from a functional structure to a multidivisional structure. This is exactly what one would predict based on our discussion around Exhibit 11.4, as firms change their organizational structures as they grow in size and complexity. Alphabet is the new parent company, overseeing 10 strategic business units, each with its own CEO and profit-and-loss responsibility.

The 10 business units start with Google's core businesses (search, ads, apps, YouTube, Android, Chrome, and Google maps) in a single unit joined by Google X (artificial intelligence, high-altitude balloons providing global internet connectivity), Waymo (self-driving cars), Nest (smart homes), Access & Energy (broadband fiber services), Verily (life sciences, smart contact lenses), Calico (longevity research), Side Walk Labs (urban innovation), Google Ventures (venture capital investments in early phase startups), and Google Capital (venture capital investments in later stage startups, similar to corporate venture capital [CVC] investments). This sweeping restructuring allows the company



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Corporate Strategy	Structure
Single business	Functional structure
Dominant business	Functional structure
Related diversification	Cooperative multidivisional (M-form) • Centralized decision making • High level of integration at corporate headquarters • Co-opetition among SBUs — Competition for resources — Cooperation in competency sharing
Unrelated diversification	Competitive multidivisional (M-form) • Decentralized decision making • Low level of integration at corporate headquarters • Competition among SBUs for resources

EXHIBIT 11.8 /
Matching Corporate
Strategy and
Structure

to separate its highly profitable search and advertising business from its “moon shots” such as providing wireless internet connectivity via high-altitude balloons or developing contact lenses that double as a “computer monitor” and provide real-time information to the wearer.

DISADVANTAGES OF M-FORM. Moving from the functional structure to the M-form results in adding another layer of corporate hierarchy (corporate headquarters). This goes along with all the known problems of increasing bureaucracy, red tape, and sometimes duplication of efforts. It also slows decision making because in many instances a CEO of an SBU must get approval from corporate headquarters when making major decisions that might affect a second SBU or the corporation as a whole.

Also, since each SBU in the M-form is evaluated as a standalone profit-and-loss center, SBUs frequently end up competing with each other. A high-performing SBU might be rewarded with greater capital budgets and strategic freedoms; low-performing businesses might be spun off. SBUs compete with one another for resources such as capital and managerial talent, but they also need to cooperate to share competencies. *Co-opetition*—competition and cooperation at the same time—among the SBUs is both inevitable and necessary. Sometimes, however, it can be detrimental when a corporate process such as resource allocation or transfer pricing between SBUs becomes riddled with corporate politics and turf wars.

In some instances, spinning out SBUs to make them independent companies is beneficial. As discussed in Chapter 8, the BCG growth-share matrix helps corporate executives when making these types of decisions. In the last few years when owned by eBay, PayPal outperformed its parent company. PayPal’s executives (and investors) were tired of subsidizing eBay’s stagnant business. eBay had bought PayPal in the aftermath of the dot-com stock market crash in 2002 for \$1.5 billion. In 2015, eBay and PayPal were de-merged. PayPal was spun out and became an independent company again. Now, PayPal is able to fully unlock its value. Investors also liked separating eBay and PayPal, giving it a valuation that is estimated to be as high as \$100 billion; eBay’s standalone valuation is about \$35 billion.³³

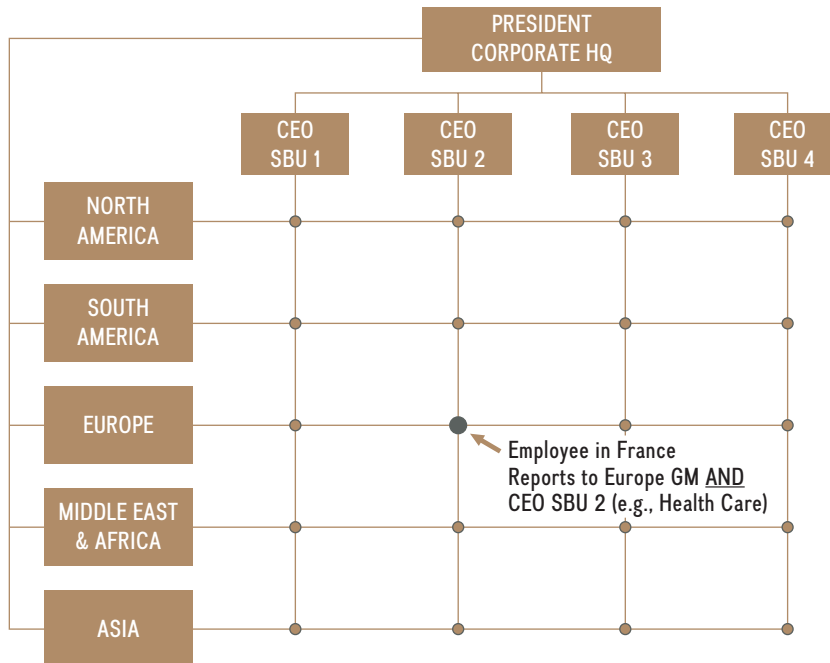
matrix structure
Organizational structure
that combines the
functional structure with
the M-form.

MATRIX STRUCTURE

To reap the benefits of both the M-form and the functional structure, many firms employ a mix of these two organizational forms, called a **matrix structure**. Exhibit 11.9 shows an example. In it, the firm is organized according to SBUs along a horizontal axis (like in the M-form), but also has a second dimension of organizational structure along a vertical axis. In this case, the second dimension consists of different geographic areas, each of which generally would house a full set of functional activities. The idea behind the matrix structure is to combine the benefits of the M-form (domain expertise, economies of scale, and the efficient processing of information) with those of the functional structure (responsiveness and decentralized focus).

The horizontal and vertical reporting lines between SBUs and geographic areas intersect, creating nodes in the matrix. Exhibit 11.9 highlights one employee, represented by a large dot and called out by an arrow. This employee works in a group with other employees in SBU 2, the company’s health care unit for the Europe division in France. This employee has two bosses—the CEO of the health care SBU and the general manager (GM) for the Europe division. Both supervisors report to corporate headquarters, which is led by the president of the corporation (indicated in Exhibit 11.9 by the reporting lines from the SBUs and geographic units to the president).

EXHIBIT 11.9 /
Typical Matrix
Structure with
Geographic and SBU
Divisions



Firms tend to use a *global matrix structure* to pursue a *transnational strategy*, in which the firm combines the benefits of a multidomestic strategy (high local responsiveness) with those of a global-standardization strategy (lowest-cost position attainable). In a global matrix structure, the geographic divisions are charged with local responsiveness and learning. At the same time, each SBU is charged with driving down costs through economies of scale and other efficiencies. A global matrix structure also allows the firm to feed local learning back to different SBUs and thus diffuse it throughout the organization. The specific organizational configuration depicted in Exhibit 11.9 is a global matrix structure.

The matrix structure is quite versatile, because managers can assign different groupings along the vertical and horizontal axes. A common form of the matrix structure uses different projects or products on the vertical axis and different functional areas on the horizontal axis. In that traditional matrix structure, *cross-functional* teams work together on different projects. In contrast to the cross-functional teams discussed earlier in the W.L. Gore example, the teams in a matrix structure tend to be more permanent rather than project-based with a predetermined time horizon.

Given the advances in computer-mediated collaboration tools, some firms have replaced the more rigid matrix structure with a *network structure*. A network structure allows the firm to connect centers of excellence, whatever their global location (see Exhibit 10.3).³⁴ The firm benefits from *communities of practice*, which store important organizational learning and expertise. To avoid undue complexity, these network structures need to be supported by corporate-wide procedures and policies to streamline communication, collaboration, and the allocation of resources.³⁵

MATRIX STRUCTURE AND GLOBAL STRATEGY. We already noted that a global matrix structure fits well with a transnational strategy. To complete the strategy–structure relationships in the global context, we also need to consider the international, multidomestic,

EXHIBIT 11.10 /

Matching Global
Strategy and
Structure

Global Strategy	Structure
International	Functional
Multidomestic	Multidivisional • Geographic areas • Decentralized decision making
Global-standardization	Multidivisional • Product divisions • Centralized decision making
Transnational	Global matrix • Balance of centralized and decentralized decision making • Additional layer of hierarchy to coordinate both: – Geographic areas – Product divisions

and standardization strategies discussed in Chapter 10. Exhibit 11.10 shows how different global strategies best match with different organizational structures.

- In an *international strategy*, the company leverages its home-based core competency by moving into foreign markets. An international strategy is advantageous when the company faces low pressure for both local responsiveness and cost reductions. Companies pursue an international strategy through a differentiation strategy at the business level. The best match for an international strategy is a *functional* organizational structure, which allows the company to leverage its core competency most effectively. This approach is similar to matching a business-level differentiation strategy with a functional structure (discussed in detail earlier).
- When a multinational enterprise (MNE) pursues a *multidomestic strategy*, it attempts to maximize local responsiveness in the face of low pressures for cost reductions. An appropriate match for this type of global strategy is the *multidivisional* organizational structure. That structure would enable the MNE to set up different divisions based on geographic regions (e.g., by continent). The different geographic divisions operate more or less as standalone SBUs to maximize local responsiveness. Decision making is decentralized.
- When following a *global-standardization strategy*, the MNE attempts to reap significant economies of scale as well as location economies by pursuing a global division of labor based on wherever best-of-class capabilities reside at the lowest cost. Since the product offered is more or less an undifferentiated commodity, the MNE pursues a cost-leadership strategy. The optimal organizational structure match is, again, a *multidivisional* structure. Rather than focusing on geographic differences as in the multidomestic strategy, the focus is on driving down costs due to consolidation of activities across different geographic areas.

DISADVANTAGES OF MATRIX STRUCTURE. Though it is appealing in theory, the matrix structure does have shortcomings. It is usually difficult to implement: Implementing two layers of organizational structure creates significant organizational complexity and increases administrative costs. Also, reporting structures in a matrix are often not clear. In particular, employees can have trouble reconciling goals presented by their two (or more)

supervisors. Less-clear reporting structures can undermine accountability by creating multiple principal–agent relationships. This can make performance appraisals more difficult. Adding an additional layer of hierarchy can also slow decision making and increase bureaucratic costs.

As just discussed, the development pattern of how organizational structures tend to change in time as firms grow in size and complexity is fairly predictable: Starting with a simple structure, then moving to functional structure, and finally implementing a multidivisional or matrix structure. As featured in the ChapterCase, Zappos even went a step further. Rapid growth and increasing complexity triggered Zappos' move away from a multidivisional structure with different business units to the radically new organizational structure, holacracy, with its nonhierarchical, overlapping employee circles. While the organizational structures shown in Exhibit 11.4 have been around for many decades, holacracy as an organizational structure is new and yet untested in larger firms, with Zappos as the sole exception.

Exhibit 11.11 summarizes the advantages and disadvantages of different organizational structures.

EXHIBIT 11.11 / Advantages and Disadvantages of Different Organizational Structures

	Advantages	Disadvantages
Simple Structure	• Fast decision-making • Nimble and responsive organization • Integration of expertise across areas • Given low bandwidth, organizations with simple structures are easily pushed into “crisis mode,” requiring “all hands on deck” (i.e., everyone working long hours until project is completed)	• CEO overload • Lack of domain expertise in distinct business functions (e.g., accounting, finance, marketing, etc.) • Unable to accommodate growth • No separation of strategic and day-to-day decision making
Functional Structure	• Clear, top-down lines of authority and decision making • Deeper domain expertise • Higher productivity due to specialization and division of labor • Responsive organization	• Emergence of silos (i.e., no effective communication across different departments) • Growth is limited • Employee alienation, especially in startups that move from simple structure to functional one
Multidivisional Structure (M-Form)	• Accommodates growth (horizontal, vertical, and geographic) • Clear profit & loss responsibilities at SBU level, run by CEO or equivalent • Efficient processing of information • Allows for different competitive strategies at SBU-level, while integration takes place at corporate level	• Additional layer of corporate hierarchy (i.e., corporate headquarters) when moving from functional to M-Form structure • SBUs stand in competition to one another • Political infighting • Opportunistic behavior by SBUs
Matrix Structure	• Accommodates growth (horizontal, vertical, and geographic) • Combines advantages of functional structure with M-Form	• Two layers of organizational structure create multiple principal–agent relationships • Slow in decision making • Potentially inaccurate performance appraisals • Quite difficult to implement

LO 11-6

Evaluate closed and open innovation, and derive implications for organizational structure.

open innovation

A framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from external ones. The sharing goes both ways: some external ideas and inventions are insourced while others are spun out.

11.3 Organizing for Innovation

After discussing the importance of innovation to gaining and sustaining competitive advantage, the question arises: How should firms organize for innovation? During the 20th century, the *closed innovation* approach was the dominant research and development (R&D) approach for most firms: They tended to discover, develop, and commercialize new products internally.³⁶ Although this approach was costly and time-consuming, it allowed firms to fully capture the returns to their own innovations.

Several factors led to a shift in the knowledge landscape from closed innovation to open innovation. They include:

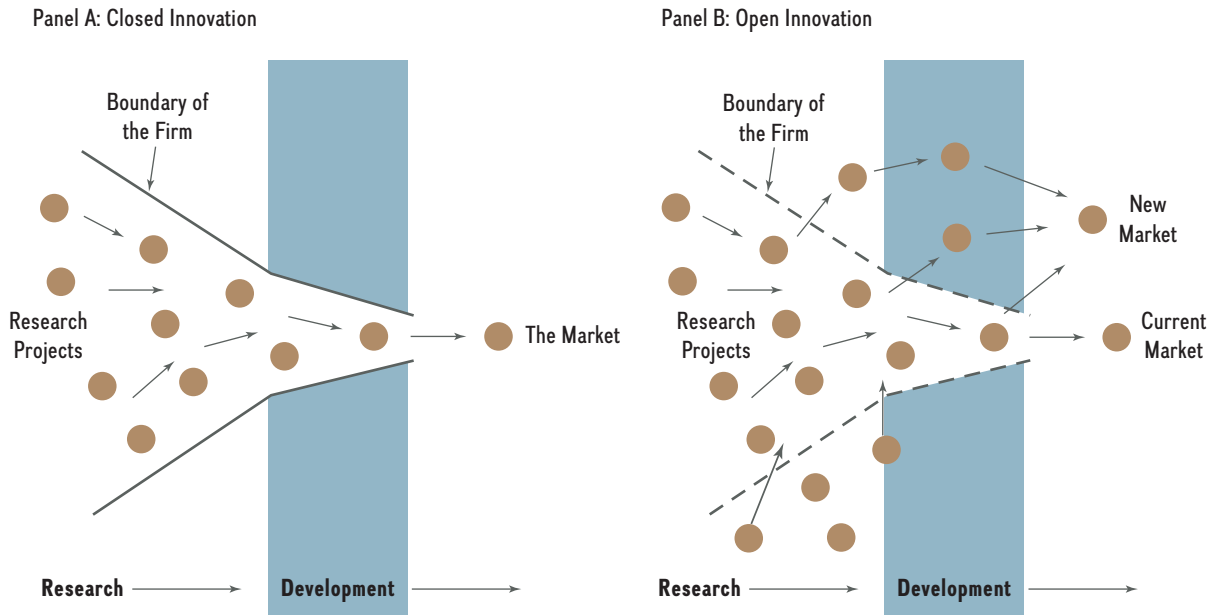
- The increasing supply and mobility of skilled workers.
- The exponential growth of venture capital.
- The increasing availability of external options (such as spinning out new ventures) to commercialize ideas that were previously shelved or insource promising ideas and inventions.
- The increasing capability of external suppliers globally.

Taken together, these factors have led more and more companies to adopt an open innovation approach to research and development. **Open innovation** is a framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from ideas and innovation from external sources. External sources of knowledge can be customers, suppliers, universities, start-up companies, and even competitors.³⁷ The sharing goes both ways: Some external R&D is insourced (and further developed in-house) while the firm may spin out internal R&D that does not fit its strategy to allow others to commercialize it. Even the largest companies, such as AT&T, IBM, and GE, are shifting their innovation strategy toward a model that blends internal with external knowledge sourcing via licensing agreements, strategic alliances, joint ventures, and acquisitions.³⁸

Exhibit 11.12 depicts the closed and open innovation models. In the closed innovation model (Panel A), the firm is conducting all research and development in-house, using a traditional funnel approach. The boundaries of the firm are impenetrable. Outside ideas and projects cannot enter, nor does the firm allow its own research ideas and development projects to leave the firm. Firms in the closed innovation model are extremely protective of their intellectual property. This not only allows the firm to capture all the benefits from its own R&D, but also prevents competitors from benefiting from it. The mind-set of firms in the closed innovation model is that to profit from R&D, the firm must come up with its own discoveries, develop them on its own, and control the distribution channels. Strength in R&D is equated with a high likelihood of benefiting from first-mover advantages. Firms following the closed innovation model, however, are much more likely to fall prone to the *not-invented-here syndrome*.³⁹ “If the R&D leading to a discovery and a new development project was not conducted in-house, it cannot be good.”

As documented, the pharmaceutical company Merck suffers from the *not-invented-here syndrome*.⁴⁰ That is, if a product was not created and developed at Merck, it could not be good enough. Merck’s culture and organizational systems perpetuate this logic, which assumes that since the company hired the best people, the smartest people in the industry must work for Merck, and so the best discoveries must be made at Merck. The company leads the industry in terms of R&D spending, because Merck believes that if it is the first to discover and develop a new drug, it would be the first to market. Merck is

EXHIBIT 11.12 / Closed Innovation vs. Open Innovation



SOURCE: Adapted from H. Chesbrough (2003), "The area of open innovation," *MIT Sloan Management Review*, Spring: 35–41.

one of the most successful companies by total number of active R&D projects. Perhaps even more important, Merck's researchers have been awarded several Nobel Prizes for their breakthrough research, a considerable point of pride for Merck's personnel.

In the open innovation model, in contrast, a company attempts to commercialize both its own ideas and research from other firms. It also finds external alternatives such as spin-out ventures or strategic alliances to commercialize its internally developed R&D. The boundary of the firm has become porous (as represented by the dashed lines in Panel B in Exhibit 11.12), allowing the firm to spin out some R&D projects while insourcing other promising projects. Companies using an open innovation approach realize that great ideas can come from both inside and outside the company. Significant value can be had by commercializing external R&D and letting others commercialize internal R&D that does not fit with the firm's strategy. The focus is on building a more effective *business model* to commercialize both internal *and* external R&D, rather than focusing on being first to market.

One key assumption underlying the open innovation model is that combining the best of internal *and* external R&D will more likely lead to a competitive advantage. This requires that the company must continuously upgrade its internal R&D capabilities to enhance its **absorptive capacity**—its ability to understand external technology developments, evaluate them, and integrate them into current products or create new ones.⁴¹ Exhibit 11.13 compares and contrasts open innovation and closed innovation principles.

Strategy Highlight 11.2 provides a detailed account over time how Sony's continued use of a closed innovation system led to a sustained competitive advantage, while Apple leveraged an open innovation model for decade-long superiority, becoming the most valuable company on the planet as a result.

absorptive capacity A firm's ability to understand external technology developments, evaluate them, and integrate them into current products or create new ones.

EXHIBIT 11.13 / Contrasting Principles of Closed and Open Innovation

Closed Innovation Principles	Open Innovation Principles
The smart people in our field work for us.	Not all the smart people work for us. We need to work with smart people inside and outside our company.
To profit from R&D, we must discover it, develop it, and ship it ourselves.	External R&D can create significant value; internal R&D is needed to claim (absorb) some portion of that value.
If we discover it ourselves, we will get it to market first.	We don't have to originate the research to profit from it; we can still be first if we successfully commercialize new research.
The company that gets an innovation to market first will win.	Building a better business model is often more important than getting to market first.
If we create the most and best ideas in the industry, we will win.	If we make the best use of internal and external ideas, we will win.
We should control our intellectual property (IP), so that our competitors don't profit from it.	We should profit from others' use of our IP, and we should buy others' IP whenever it advances our own business model.

SOURCE: Adapted from H.W. Chesbrough (2003), *Open Innovation: The New Imperative for Creating and Profiting from Technology* (Boston: Harvard Business School Press).

Strategy Highlight 11.2

Sony vs. Apple: Whatever Happened to Sony?

Apple's market capitalization in 2001 was \$7 billion, while Sony's was \$55 billion. In other words, Sony was almost eight times larger than Apple. Then most people would have picked Sony as the company to revolutionize the mobile device industry given its stellar innovation track record. Instead that honor goes to Apple, when it introduced the iPod, a portable digital music player, in October 2001, and the iTunes Music Store 18 months later. Through these two strategic moves Apple redefined the music industry, reinventing itself as not only a mobile-device but also a content-delivery company. Many observers wondered what happened to Sony, the company that created the portable music industry by introducing the Walkman in 1979.

Sony's strategy was to differentiate itself through the vertical integration of content and hardware, driven by its 1988 acquisition of CBS Records (later part of Sony Entertainment) and its 1989 acquisition of Columbia Pictures. This vertical integration strategy contrasted sharply with Sony Music division's desire to protect its lucrative revenue-generating, copyrighted compact discs (CDs). Sony Music's engineers were aggressively combating rampant music piracy by inhibiting the Microsoft Windows media player's ability to rip CDs and by serializing discs (assigning unique ID numbers to discs). The compact disc (CD) became the dominant



Sony created the portable music industry with the Walkman, introduced in 1979.

©Chris Willson / Alamy Stock Photo

format for selling music in 1991, replacing analog audiocassettes. The CD had been jointly developed by Sony and European electronics manufacturer Philips.

Media technology, however, soon moved to digital. With the rise of the internet in the 1990s and use of digital music, illegal file sharing on the internet was rampant. Napster allowed peer-to-peer sharing of files, which meant individual users could upload entire albums of music, to be downloaded by anyone, with no payments going to the artists or the record companies. While Sony focused on preventing media players that could rip CDs, Apple was developing a digital rights management (DRM) system to allow for legal downloads of digital music while protecting copyright at the same time. The iTunes Store enabled users to legally download and own individual songs at an attractive 99 cents. Apple's DRM and iTunes succeeded, protecting the music studios' and artists' interests while creating value that enabled consumers to enjoy portable digital music.

Sony had a long history of creating category-defining electronic devices of superior quality and design using a closed innovation approach. It had all the right competencies in-house to launch a successful counterattack to compete with Apple: electronics, software, music, and computer divisions. Sony even supplied the batteries for Apple's iPod. Cooperation among strategic business units had served Sony well in the past, leading to breakthrough innovations such as the Walkman, PlayStation, CD, and VAIO computer line. In digital music, however, the hardware and content divisions each seemed to have its own idea of what needed to be done. Cooperation among the Sony divisions was also hindered by the fact that their centers of operations were spread across the globe: Music operations were located in New York City and electronics design was in Japan, inhibiting face-to-face communications and making real-time interactions more difficult.

Nobuyuki Idei, then CEO of Sony, learned the hard way that the music division managers were focused on the immediate needs of their recordings competing against the

consumer-driven market forces. In 2002, Idei shared his frustrations with the cultural differences between the hardware and content divisions:

The opposite of soft alliances is hard alliances, which include mergers and acquisitions. Since purchasing the Music and Pictures businesses, more than 10 years have passed, and we have experienced many cultural differences between hardware manufacturing and content businesses. . . . This experience has taught us that in certain areas where hard alliances would have taken 10 years to succeed, soft alliances can be created more easily. Another advantage of soft alliances is the ability to form partnerships with many different companies. We aim to provide an open and easy-to-access environment where anybody can participate, and we are willing to cooperate with companies that share our vision. Soft alliances offer many possibilities.⁴²

In contrast, Apple organized a small, empowered, cross-functional team to produce the iPod in just a few months. Using open innovation, Apple successfully insourced many of its components from external partners (including from Sony and Samsung), and then integrated them. The phenomenal speed and success of the iPod and iTunes development and seamless integration of hardware and software became a structural approach that Apple applied to its successful development and launches of other category-defining products such as the iPhone, iPad, and Apple Watch.

Apple's market capitalization has grown from a paltry \$7 billion in 2001 to over \$800 billion in 2017, making it the most valuable company globally. (Apple was the first company ever to cross the \$800 billion valuation threshold). In contrast, Sony's market capitalization has dropped from \$55 billion in 2001 to some \$45 billion in 2017. The different ways to organize and implement innovation had a great deal to do with this outcome!⁴³

11.4 Organizational Culture: Values, Norms, and Artifacts

Organizational culture is the second key building block when designing organizations for competitive advantage. Just as people have distinctive personalities, so too do organizations have unique cultures that capture “how things get done around here.” **Organizational culture** describes the collectively shared values and norms of an organization's members.⁴⁴ *Values* define what is considered important. *Norms* define appropriate employee attitudes and behaviors.⁴⁵

LO 11-7

Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

organizational culture The collectively shared values and norms of an organization's members; a key building block of organizational design.

Employees learn about an organization's culture through *socialization*, a process whereby employees internalize an organization's values and norms through immersion in its day-to-day operations.⁴⁶ Zappos' new-employee orientation and immersion is now a four-week course. Successful socialization, in turn, allows employees to function productively and to take on specific roles within the organization. *Strong cultures* emerge when the company's core values are widely shared among the firm's employees and when the norms have been internalized.

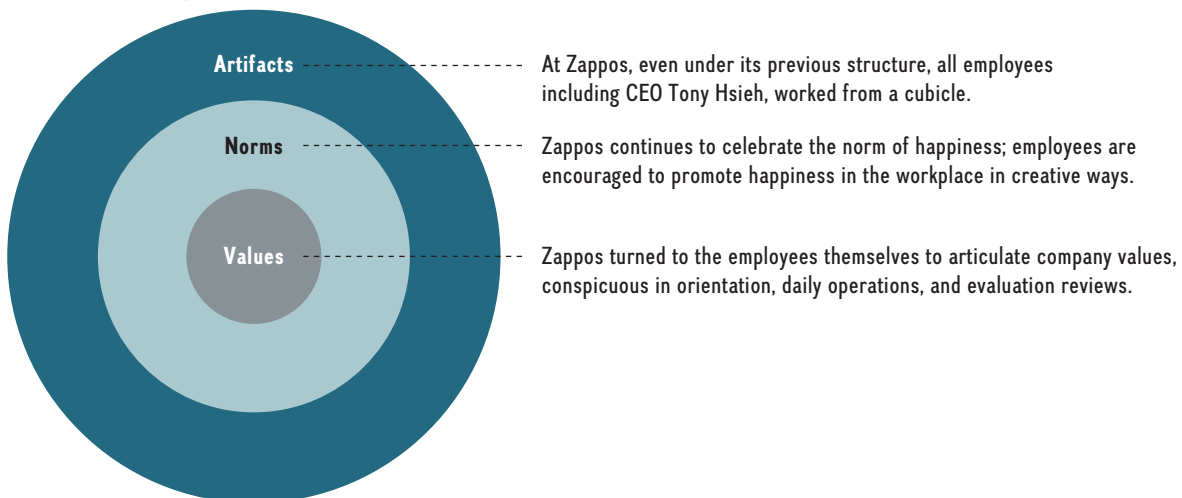
Corporate culture finds its expression in *artifacts*. Artifacts include elements such as the design and layout of physical space (e.g., cubicles or private offices), symbols (e.g., the type of clothing worn by employees), vocabulary, what stories are told (see the Zappos pizza-ordering example that follows), what events are celebrated and highlighted, and how they are celebrated (e.g., a formal dinner versus a casual barbecue when the firm reaches its sales target).

Exhibit 11.14 depicts the elements of organizational culture—values, norms, and artifacts—in concentric circles. The most important yet least visible element—values—is in the center. As we move outward in the figure, from values to norms to artifacts, culture becomes more observable. Understanding what organizational culture is, and how it is created, maintained, and changed, can help you be a more effective manager. A unique culture that is strategically relevant can also be the basis of a firm's competitive advantage.

As Zappos grew, its managers realized that it was critical to explicitly define a set of core values from which to develop the company's culture, brand, and strategy. Zappos CEO Tony Hsieh wanted to make sure all employees understood the same set of values and expected behaviors. Zappos' list of 10 core values (see Exhibit 11.15) was crafted through a bottom-up initiative, in which all employees were invited to participate.

To live up to its mission of delivering happiness, Zappos decided that exceptional customer service should be its number-one core value. The company put several policies and procedures in place to “deliver WOW through service.” For example, shipments to and from customers within the United States are free, allowing customers to order several pairs of shoes and send back (within a liberal 365 days) those that don't fit or

EXHIBIT 11.14 / The Elements of Organizational Culture: Values, Norms, and Artifacts



are no longer wanted. Repeat customers are automatically upgraded to complimentary express shipping. One of the most important lessons Hsieh learned is “Never outsource your core competency!”⁴⁷ Customer service, therefore, is done exclusively in-house.

Perhaps even more importantly, Zappos does not provide a script or measure customer service reps’ call times. Rather, the company leaves it up to the individual member of the “Customer Loyalty Team” to deliver exceptional customer service: “We want our reps to let their true personalities shine during each phone call so that they can develop a personal emotional connection with the customer.”⁴⁸ In fact, one customer service phone call lasted almost six hours! The same trust in the customer service reps applies to e-mail communication. Zappos’ official communication policy is to “be real and use your best judgment.”⁴⁹ Most of Zappos’ more than 1,500 employees are in some type of sales function, to maintain constant contact with the customer. The customer call centers are staffed 24/7, seven days a week, 365 days a year.

Zappos’ third core value, “create fun and a little weirdness,” encourages a unique culture based on shared experiences including costume play (“cosplay”) at work, parades, fun contests, themed courtyard events, ice cream trucks, Nerf guns, Ping-Pong, live animals, and so on.⁵⁰ One of the hardest choices Zapponians need to make each day is choosing which fun event to support, including trivia nights, family picnics, pinewood derby races, talent shows, Foosball, snow sledding, spring break days, pajama days, and karaoke. This is all just part of another day at the Zappos office.

Besides creating a strong culture that binds employees together through shared fun experiences, Zappos believes that encouraging a little weirdness and fun helps people to think outside the box and thus be more creative and innovative. All this helps to achieve their number-one core value to “deliver WOW through service,” but also other core values such as “do more with less.” Taken together, employees are more engaged in their work, not only with their hands, but also their minds and hearts, and the company is being more innovative and nimble as a whole.

EXHIBIT 11.15 / Zappos 10 Core Values

1. Deliver WOW through service.
2. Embrace and drive change.
3. Create fun and a little weirdness.
4. Be adventurous, creative, and open-minded.
5. Pursue growth and learning.
6. Build open and honest relationships with communication.
7. Build a positive team and family spirit.
8. Do more with less.
9. Be passionate and determined.
10. Be humble.

SOURCE: T. Hsieh (2010), *Delivering Happiness: A Path to Profits, Passion, and Purpose* (New York: Business Plus), 157–160.



WHERE DO ORGANIZATIONAL CULTURES COME FROM?

Often, company founders define and shape an organization’s culture, which can persist for many decades after their departure. This phenomenon is called **founder imprinting**.⁵¹ Founders set the initial strategy, structure, and culture of an organization by transforming their vision into reality. Famous founders who have left strong imprints on their organizations include Steve Jobs (Apple), Walt Disney (Disney), Michael Dell (Dell), Sergey Brin and Larry Page (Google), Oprah Winfrey (Harpo Productions and OWN, the Oprah Winfrey Network),

The core value “creating fun and a little weirdness” is reflected in the relaxed and colorful office space in the Zappos office in Las Vegas, Nevada.

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founder imprinting

A process by which the founder defines and shapes an organization's culture, which can persist for decades after his or her departure.

groupthink

A situation in which opinions coalesce around a leader without individuals critically evaluating and challenging that leader's opinions and assumptions.

Martha Stewart (Martha Stewart Living Omnimedia), Bill Gates (Microsoft), Larry Ellison (Oracle), Ralph Lauren (Polo Ralph Lauren), Herb Kelleher (Southwest Airlines), and Elon Musk (Tesla and SpaceX).

Walmart founder Sam Walton personified the retailer's cost-leadership strategy. At one time the richest man in America, Sam Walton drove a beat-up Ford pickup truck, got \$5 haircuts, went camping for vacations, and lived in a modest ranch home in Bentonville, Arkansas.⁵² Everything Walton did was consistent with the low-cost strategy. Walmart stays true to its founder's tradition. Home to one of the largest companies on the planet, the company's Arkansas headquarters in Bentonville was described by Thomas Friedman in his book *The World Is Flat* as "crammed into a reconfigured warehouse . . . a large building made of corrugated metal, I figured it was the maintenance shed."⁵³

The culture that founders initially imprint is reinforced by their strong preference to recruit, retain, and promote employees who subscribe to the same values. In turn, more people with similar values are attracted to that organization.⁵⁴ As the values and norms held by the employees become more similar, the firm's corporate culture becomes stronger and more distinct. This in turn can have a serious negative side-effect: **groupthink**, a situation in which opinions coalesce around a leader without individuals critically evaluating and challenging that leader's opinions and assumptions. Cohesive, non-diverse groups are highly susceptible to groupthink, which in turn can lead to flawed decision making with potentially disastrous consequences.

In addition to founder imprinting, a firm's culture also flows from its values, especially when they are linked to the company's reward system. For example, Zappos established its unique organizational culture through explicitly stated values that are connected to its reward system (see Exhibit 11.15). To recruit people that fit with the company's values, Hsieh has all new hires go through a four-week training program. It covers such topics as company history, culture, and vision, as well as customer service.⁵⁵ New hires also spend two weeks on the phone as customer service reps. What's novel about Zappos' approach is that at the end of the monthlong employee orientation, the company offers an "exit prize": one month's pay plus pay for the time already with Zappos. This allows the company to entice people to leave that are qualified for the job but may not fit with Zappos' culture. Individuals who choose to stay despite the enticing offer tend to fit well with and strengthen Zappos' distinct culture.⁵⁶



Mary Barra, General Motors CEO.

©Jeff Kowalsky/Bloomberg/Getty Images

HOW DOES ORGANIZATIONAL CULTURE CHANGE?

An organization's culture can be one of its strongest assets, but also its greatest liability. An organization's culture can turn from a core competency into a *core rigidity* if a firm relies too long on the competency without honing, refining, and upgrading as the firm and the environment change.⁵⁷ (See discussion in Chapter 4.) Over time, the original core competency is no longer a good fit and turns from an asset into a liability. This is the time when a culture needs to change.

GM's bureaucratic culture, combined with its innovative M-form structure, was once hailed as the key to superior efficiency and management.⁵⁸ However, that culture became a liability when the external environment changed following the oil-price shocks in the 1970s and the entry of Japanese carmakers into the United States.⁵⁹ As a consequence, GM's strong culture led to organizational inertia. This resulted in a failure to adapt to changing customer preferences for more

fuel-efficient cars, and it prevented higher quality and more innovative designs. GM lost customers to foreign competitors that offered these features.

More recently, GM's strong culture was again faulted for corporate ineptitude when delaying recalling defective cars.⁶⁰ In 2014, over 25 million GM cars were recalled for safety defects, the largest recall ever. In particular, many GM cars were eventually recalled because of a faulty ignition switch, which could turn off the engine while driving and thus disable the airbags. This problem has been linked to more than 120 fatalities in the United States alone.⁶¹ GM is alleged to knowingly have withheld information about the faulty ignition switches and delayed the needed recalls by several years. Indeed, during a U.S. Senate hearing, GM was described as dominated by a "culture of cover-up."⁶² In such times of crisis, corporate culture must be changed to avoid such problems in the future and to address a breakdown in the culture-environment fit.

The primary means of cultural change is for the corporate board of directors to bring in new leadership at the top, which is then charged to make changes in strategy and structure. After all, executives shape corporate culture in their decisions on how to structure the organization and its activities, allocate its resources, and develop its system of rewards (see the discussion on strategic leadership in Chapter 2). In 2014, GM's board of directors appointed Mary Barra as CEO with the charge to fix GM's dysfunctional corporate culture and to make the company competitive again.

Similarly, when Marissa Mayer was appointed CEO of Yahoo in 2012, one of the first things she did was to change the corporate culture and norms. Yahoo had become overly bureaucratic and lost the zeal characteristic of high-tech startups. Many Yahoo employees worked from home. For those who worked in the office, weekends began Thursday afternoons, leaving empty parking garages at Yahoo's campus in Sunnyvale, California. In response, Mayer withdrew the option to work remotely. All of Yahoo's 12,000 employees would have to come to the office. She also instituted weekly town-hall meetings (called FYI) where she and other executives provided updates and fielded questions. All employees were expected to attend and encouraged to participate in the Q&A. Questions were submitted online during the week, and the employees voted which questions executives should respond to. Although Mayer succeeded in reenergizing the once leading internet firm, in the end, a successful turnaround failed and Yahoo was acquired by Verizon for a fire sale price.

ORGANIZATIONAL CULTURE AND COMPETITIVE ADVANTAGE

Can organizational culture be the basis of a firm's competitive advantage? For this to occur, the firm's unique culture must help it in some way to increase its *economic value creation* ($V-C$). That is, it must either help in increasing the perceived value of the product/service and/or lower its cost of production/delivery. Moreover, according to the resource-based view of the firm, the resource—in this case, organizational culture—must be *valuable*, *rare*, *difficult to imitate*, and the firm must be *organized* to capture the value created. The VRIO principles (see Chapter 4) must apply even as to organizational culture itself.⁶³

Let's look at two examples of how culture affects employee behavior and ultimately firm performance:

- If you have flown with Southwest Airlines (SWA), you may have noticed that things are done a little differently there. Flight attendants might sing a song about the city you're landing in, or they might slide bags of peanuts down the aisle at takeoff. Employees celebrate Halloween in a big way by wearing costumes to work. Some argue that SWA's business strategy—being a cost leader in point-to-point air travel—is fairly simple, and that SWA's competitive advantage actually comes from its unique culture.⁶⁴ It's not all fun and games, though: Friendly and highly energized employees

work across functional and hierarchical levels. Even Southwest's pilots pitch in to help load baggage quickly when needed. As a result, SWA's turn time between flights is only 15 minutes, whereas competitors frequently take two to three times as long.

- Zappos' number-one core value is to "deliver WOW through service." CEO Hsieh shares the following story to illustrate this core value in action: "I was in Santa Monica, California, a few years ago at a Skechers sales conference. . . . [In the early hours of the morning], a small group of us headed up to someone's hotel room to order some food. My friend from Skechers tried to order a pepperoni pizza from the room-service menu but was disappointed to learn that the hotel did not deliver hot food after 11:00 p.m. We had missed the deadline by several hours. . . . A few of us cajoled her into calling Zappos to try to order a pizza. She took us up on our dare, turned on the speakerphone, and explained to the (very) patient Zappos rep that she was staying in a Santa Monica hotel and really craving a pepperoni pizza, that room service was no longer delivering hot food, and that she wanted to know if there was anything Zappos could do to help. The Zappos rep was initially a bit confused by the request, but she quickly recovered and put us on hold. She returned two minutes later, listing the five closest places in the Santa Monica area that were still open and delivering pizzas at that time."⁶⁵

In the SWA example, the company's unique culture helps it keep costs low by turning around its planes faster, thus keeping them flying longer hours (among many other activities that lower SWA's cost structure).⁶⁶ In the Zappos example, providing a "wow" customer experience by "going the extra mile" didn't save Zappos money, but in the long run superior experience does increase the company's perceived value and thereby its economic value creation. Indeed, Hsieh makes it a point to conclude the story with the following statement: "As for my friend from Skechers? After that phone call, she's now a customer for life."⁶⁷

Let's consider how an organization's culture can have a strong influence on employee behavior.⁶⁸ A positive culture motivates and energizes employees by appealing to their higher ideals. Internalizing the firm's values and norms, employees feel that they are part of a larger, meaningful community attempting to accomplish important things. When employees are intrinsically motivated this way, the firm can rely on fewer levels of hierarchy; thus, close monitoring and supervision are not needed as much. Motivating through inspiring values allows the firms to tap employees' emotions so they use both their heads and their hearts when making business decisions. Strong organizational cultures that are strategically relevant, therefore, align employees' behaviors more fully with the organization's strategic goals. In doing so, they better coordinate work efforts, and they make cooperation more effective. They also strengthen employee commitment, engagement, and effort. Effective alignment in turn allows the organization to develop and refine its core competencies, which can form the basis for competitive advantage.

Applying the VRIO principles to the SWA and Zappos examples, we see that both cultures are *valuable* (lowering costs for SWA and increasing perceived value created for Zappos), *rare* (none of their competitors has an identical culture), *non-imitable* (despite attempts by competitors), and *organized* to capture some part of the incremental economic value created due to their unique cultures. It appears that at both SWA and Zappos, a unique organizational culture can provide the basis for a competitive advantage. These cultures, of course, need to be in sync with and in support of the respective business strategies pursued: cost leadership for SWA and differentiation for Zappos. Moreover, as the firms grow and external economic environments change, these cultures must be flexible enough to adapt.

Once it becomes clear that a firm's culture is a source of competitive advantage, some competitors will attempt to imitate that culture. Therefore, only a culture that cannot be easily copied can provide a competitive advantage. It can be difficult, at best, to imitate the cultures of successful firms, for two reasons: *causal ambiguity* and *social complexity*. While one can

observe that a firm has a unique culture, the causal relationships among values, norms, artifacts, and the firm's performance may be hard to establish, even for people who work within the organization. For example, employees may become aware of the effect culture has on performance only after significant organizational changes occur. Moreover, organizational culture is socially complex. It encompasses not only interactions among employees across layers of hierarchy, but also the firm's outside relationships with its customers and suppliers.⁶⁹ Such a wide range of factors is difficult for any competing firm to imitate.

It is best to develop a strong and strategically relevant culture in the first few years of a firm's existence. Strategy scholars have documented that the initial structure, culture, and control mechanisms established in a new firm can be a significant predictor of later success.⁷⁰ In other empirical research, founder CEOs had a stronger positive imprinting effect than non-founder CEOs.⁷¹ This stronger imprinting effect, in turn, resulted in higher performance of firms led by founder CEOs. In addition, consider that the vehicles of cultural change—changing leadership and M&As—do not have a stellar record of success.⁷² Indeed, researchers estimate that only about 20 percent of organizational change attempts are successful.⁷³ Thus, it is even more important to get the culture right from the beginning and then adapt it as the business evolves.

By combining theory and empirical evidence, we can see that organizational culture can help a firm gain and sustain competitive advantage *if* the culture makes a positive contribution to the firm's economic value creation and obeys the VRIO principles. Organizational culture is an especially effective lever for new ventures due to its malleability. Firm founders, early-stage CEOs, and venture capitalists, therefore, should be proactive in attempting to create a culture that supports a firm's economic value creation.

11.5 Strategic Control-and-Reward Systems

Strategic control-and-reward systems are the third and final key building block when designing organizations for competitive advantage. **Strategic control-and-reward systems** are internal-governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees). These systems allow managers to specify goals, measure progress, and provide performance feedback.

Zappos restructured its performance-evaluation system to give these values teeth: The firm rewards employees who apply the values (shown in Exhibit 11.15) well in their day-to-day decision making. It created an open market (referred to internally as OM) based on an online scheduling platform that allows customer service employees to select their work hours. The novel tweak in the OM system is that it compensates customer service employees based on a surge-pricing payment model (first popularized by the taxi-hailing service, Uber). Hsieh states, “Ideally, we want all 10 core values to be reflected in everything we do, including how we interact with each other, how we interact with our customers, and how we interact with our vendors and business partners. . . . Our core values should always be the framework from which we make all of our decisions.”⁷⁴ Zappos' 10 core values are important to its employees; they define their identity of what it means to be working at Zappos.⁷⁵

Chapter 5 discussed how firms can use the balanced-scorecard framework as a strategic control system. Here, we discuss additional control-and-reward systems: organizational culture, input controls, and output controls.

As just demonstrated, *organizational culture* can be a powerful motivator. It also can be an effective control system. Norms, informal and tacit in nature, act as a social control mechanism. Zappos, for example, achieves organizational control partly through an employee's peer group: Each group member's compensation, including the supervisor's, depends in part on the group's overall productivity. Peer control, therefore, exerts a powerful force on employee conformity and performance.⁷⁶ Values and norms also provide

LO 11-8

Compare and contrast different strategic control-and-reward systems.

strategic control-and-reward systems

Internal-governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees).

control by helping employees address unpredictable and irregular situations and problems (common in service businesses). In contrast, rules and procedures (e.g., codified in an employee handbook) can address only circumstances that can be predicted.

INPUT CONTROLS

input controls

Mechanisms in a strategic control-and-reward system that seek to define and direct employee behavior through a set of explicit, codified rules and standard operating procedures that are considered before the value-creating activities.

Input controls seek to define and direct employee behavior through a set of explicit, codified rules and standard operating procedures. Firms use input controls when the goal is to define the ways and means to reach a strategic goal and to ensure a predictable outcome. They are called input controls because management designs these mechanisms so they are considered *before* employees make any business decisions; thus, they are an input into the value-creating activities.

The use of *budgets* is key to input controls. Managers set budgets before employees define and undertake the actual business activities. For example, managers decide how much money to allocate to a certain R&D project before the project begins. In diversified companies using the M-form, corporate headquarters determines the budgets for each division. Public institutions, like some universities, also operate on budgets that must be balanced each year. Their funding often depends to a large extent on state appropriations and thus fluctuates depending on the economic cycle. During recessions, budgets tend to be cut, and they expand during boom periods.

Standard operating procedures, or policies and rules, are also a frequently used mechanism when relying on input controls. The discussion on formalization described how McDonald's relies on detailed operating procedures to ensure consistent quality and service worldwide. The goal is to specify the conversion process from beginning to end in great detail to guarantee standardization and minimize deviation. This is important when a company operates in different geographies and with different human capital throughout the globe but needs to deliver a standardized product or service.

OUTPUT CONTROLS

output controls

Mechanisms in a strategic control-and-reward system that seek to guide employee behavior by defining expected results (outputs), but leave the means to those results open to individual employees, groups, or SBUs.

Output controls seek to guide employee behavior by defining expected results (outputs), but leave the means to those results open to individual employees, groups, or SBUs. Firms frequently tie employee compensation and rewards to predetermined goals, such as a specific sales target or return on invested capital. When factors internal to the firm determine the relationship between effort and expected performance, outcome controls are especially effective. At the corporate level, outcome controls discourage collaboration among different strategic business units. They are best applied when a firm focuses on a single line of business or pursues unrelated diversification.

These days, more and more work requires creativity and innovation, especially in highly developed economies.⁷⁷ As a consequence, so-called *results-only-work-environments (ROWEs)* have attracted significant attention. ROWEs are output controls that attempt to tap intrinsic (rather than extrinsic) employee motivation, which is driven by the employee's interest in and the meaning of the work itself. In contrast, extrinsic motivation is driven by external factors such as awards and higher compensation, or punishments like demotions and layoffs (the *carrot-and-stick approach*). According to a recent synthesis of the strategic human resources literature, intrinsic motivation in a task is highest when an employee has:

- Autonomy (*about what to do*).
- Mastery (*how to do it*).
- Purpose (*why to do it*).⁷⁸

Today, 3M is best known for its adhesives and other consumer and industrial products.⁷⁹ But its full name reflects its origins: 3M stands for Minnesota Mining and

Manufacturing Co. Over time, 3M has relied on the ROWE framework and has morphed into a highly science-driven innovation company. At 3M, employees are encouraged to spend 15 percent of their time on projects of their *own choosing*. If any of these projects look promising, 3M provides financing through an internal venture capital fund and other resources to further develop their commercial potential. In fact, several of 3M's flagship products, including Post-it Notes and Scotch Tape, were the results of serendipity. To foster continued innovation, moreover, 3M requires each of its divisions to derive at least 30 percent of their revenues from products introduced in the past four years.

11.6 Implications for Strategic Leaders

This chapter has a clear practical implication for the strategist: Formulating an effective strategy is a necessary but not sufficient condition for gaining and sustaining competitive advantage; strategy *execution* is at least as important for success.

The key levers for strategic leaders to achieve effective strategy implementation are: structure, culture, and control. Successful strategy implementation, therefore, requires leaders to design and shape structure, culture, and control mechanisms. In doing so, they execute a firm's strategy as they put its accompanying business model into action. Strategy formulation and strategy implementation, therefore, are iterative and interdependent activities.

Some argue that strategy implementation is more important than strategy formulation.⁸⁰ Often, managers do a good job of analyzing the firm's internal and external environments to formulate a promising business, corporate, and global strategy, but then fail to implement the chosen strategy successfully. That is why some scholars refer to implementation as the "graveyard of strategy."⁸¹ In reality, both strategy formulation *and* strategy implementation are necessary to gain and sustain a competitive advantage.

As a company grows and its operations become more complex, it adopts different organizational structures over time following a generally predictable pattern: beginning with a simple structure, then a functional structure, and followed by a multidivisional or matrix structure. Organizing for competitive advantage, therefore, is a dynamic and not a static process. As seen in the Zappos example discussed throughout the chapter, to maintain competitive advantage, companies need to restructure as they grow and the competitive environment changes.

Organizing for innovation is another area that strategic leaders need to pay careful attention to. Many of the more successful companies have either adopted or are moving toward an open innovation model. Strategic leaders must actively manage a firm's internal and external innovation activities. Internally, one can *induce innovation* through a top-down process or motivate innovation through *autonomous actions*, a bottom-up process.⁸² In induced innovation, strategic leaders need to put a structure and system in place to foster innovation. Consider 3M: "A core belief of 3M is that creativity needs freedom. That's why . . . we've encouraged our employees to spend 15 percent of their working time on their own projects. To take our resources, to build up a unique team, and to follow their own insights in pursuit of problem-solving."⁸³ We discussed *autonomous actions* in detail in Chapter 2. To not only motivate innovations through autonomous behavior, but also ensure their possible success, *internal champions* need to be willing to support promising projects. In Strategy Highlight 2.1, we detailed how Howard Behar, at that time a senior executive at Starbucks, was willing to support the bottom-up idea of Frappuccino, which turned out to be a multibillion-dollar business. Externally, strategic leaders must manage innovation through cooperative strategies such as licensing, strategic alliances, joint ventures, and acquisitions. These are the vehicles of *corporate strategy* discussed previously.

This concludes our discussion of organizational design. We now move on to our concluding chapter, where we study corporate governance and business ethics.

CHAPTERCASE 11 / Consider This . . .

ZAPPOS' IMPLEMENTATION OF holacracy is not going well. As a consequence, employee morale has plummeted, and Zappos employees are no longer as happy. In 2011, Zappos was ranked sixth in *Fortune's* "100 Best Companies to Work For" list (one of the highest rankings for a relatively young firm). By 2015, after it started implementing holacracy, Zappos had dropped to rank 86! And in 2016 and 2017, Zappos failed to place in *Fortune's* "100 Best Companies to Work For" ranking. The ranking is determined by what employees say about their own company in anonymous surveys—not some arbitrary external assessment.⁸⁴

In 2015, Hsieh was frustrated that the transition to holacracy, announced in 2013, was not yet complete, so to accelerate the process, he offered a three-month severance package to employees not willing to adopt the new structure. More than 200 employees, or some 14 percent of Zappos' work force, accepted the offer and quit. As of January 2016, Zappos had lost 18 percent of its work-force. Employees that remain with Zappos complain that the holacracy implementation removes clear career paths for advancement and wonder openly how hiring, firing, and promoting will now be done. They are concerned that relying on employee circles for making decisions will not only induce paralysis, but also make the organization more and not less political. In sum, they find that holacracy forces them to waste time in endless meetings rather than getting the actual work done.

After the initial implementation struggle, Hsieh remains committed and is doubling down on holacracy implementation. He expressed his frustration about the slow process and lack of productivity gains in a lengthy e-mail to all Zappos employees, which was subsequently leaked to the business press. He notes that business results reportedly remain good, and that 82 percent of the workers are staying. At the same time, the irony that Hsieh decreed top-down that Zappos would be implementing holacracy (or decided a few years earlier to sell the company to Amazon.com), in a company that ostensibly celebrated democracy and participation, wasn't lost on the company's workers.⁸⁵



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Questions

1. What elements of an organic organization are apparent from the chapter material on Zappos? (Refer to Exhibit 11.3.)
2. What is holacracy, and how does this organizational structure differ from the more traditional ones discussed in this chapter?
3. Why is Zappos experiencing significant implementation problems with holacracy? What else could Zappos do to help implement the new structure more effectively?
4. Do you think that holacracy is a good match with Zappos' business strategy? Why or why not? Explain.

TAKE-AWAY CONCEPTS

This chapter explored the three key levers that managers have at their disposal when designing their firms for competitive advantage—structure, culture, and control—as summarized by the following learning objectives and related take-away concepts.

LO 11-1 / Define organizational design and list its three components.

- Organizational design is the process of creating, implementing, monitoring, and modifying the structure, processes, and procedures of an organization.

- The key components of organizational design are structure, culture, and control.
- The goal is to design an organization that allows managers to effectively translate their chosen strategy into a realized one.

LO 11-2 / Explain how organizational inertia can lead established firms to failure.

- Organizational inertia can lead to the failure of established firms when a tightly coupled system of strategy and structure experiences internal or external shifts.

- Firm failure happens through a dynamic, four-step process (see Exhibit 11.2).

LO 11-3 / Define organizational structure and describe its four elements.

- An organizational structure determines how firms orchestrate employees' work efforts and distribute resources. It defines how firms divide and integrate tasks, delineates the reporting relationships up and down the hierarchy, defines formal communication channels, and prescribes how employees coordinate work efforts.
- The four building blocks of an organizational structure are specialization, formalization, centralization, and hierarchy (see Exhibit 11.3).

LO 11-4 / Compare and contrast mechanistic versus organic organizations.

- Organic organizations are characterized by a low degree of specialization and formalization, a flat organizational structure, and decentralized decision making.
- Mechanistic organizations are described by a high degree of specialization and formalization, and a tall hierarchy that relies on centralized decision making.
- The comparative effectiveness of mechanistic versus organic organizational forms depends on the context.

LO 11-5 / Describe different organizational structures and match them with appropriate strategies.

- To gain and sustain competitive advantage, not only must structure follow strategy, but also the chosen organizational form must match the firm's business strategy.
- The strategy–structure relationship is dynamic, changing in a predictable pattern—from simple to functional structure, then to multidivisional (M-form) and matrix structure—as firms grow in size and complexity.
- In a simple structure, the founder tends to make all the important strategic decisions as well as run the day-to-day operations.
- A functional structure groups employees into distinct functional areas based on domain expertise. Its different variations are matched with different business strategies: cost leadership, differentiation, and blue ocean (see Exhibit 11.6).

- The multidivisional (M-form) structure consists of several distinct SBUs, each with its own profit-and-loss responsibility. Each SBU operates more or less independently from one another, led by a CEO responsible for the business strategy of the unit and its day-to-day operations (see Exhibit 11.7).
- The matrix structure is a mixture of two organizational forms: the M-form and the functional structure (see Exhibit 11.9).
- Exhibits 11.8 and 11.10 show how best to match different corporate and global strategies with respective organizational structures.

LO 11-6 / Evaluate closed and open innovation, and derive implications for organizational structure.

- Closed innovation is a framework for R&D that proposes impenetrable firm boundaries. Key to success in the closed innovation model is that the firm discovers, develops, and commercializes new products internally.
- Open innovation is a framework for R&D that proposes permeable firm boundaries to allow a firm to benefit not only from internal ideas and inventions, but also from external ones. The sharing goes both ways: some external ideas and inventions are insourced while others are spun out.
- Exhibit 11.3 compares and contrasts principles of closed and open innovation.

LO 11-7 / Describe the elements of organizational culture, and explain where organizational cultures can come from and how they can be changed.

- Organizational culture describes the collectively shared values and norms of its members.
- Values define what is considered important, and norms define appropriate employee attitudes and behaviors.
- Corporate culture finds its expression in artifacts, which are observable expressions of an organization's culture.

LO 11-8 / Compare and contrast different strategic control-and-reward systems.

- Strategic control-and-reward systems are internal governance mechanisms put in place to align the incentives of principals (shareholders) and agents (employees).

- Strategic control-and-reward systems allow managers to specify goals, measure progress, and provide performance feedback.
- In addition to the balanced-scorecard framework, managers can use organizational culture, input controls, and output controls as part of the firm's strategic control-and-reward systems.
- Input controls define and direct employee behavior through explicit and codified rules and standard operating procedures.
- Output controls guide employee behavior by defining expected results, but leave the means to those results open to individual employees, groups, or SBUs.

KEY TERMS

Absorptive capacity (<i>p. 399</i>)	Groupthink (<i>p. 404</i>)	Organic organization (<i>p. 386</i>)
Ambidexterity (<i>p. 390</i>)	Hierarchy (<i>p. 385</i>)	Organizational culture (<i>p. 401</i>)
Ambidextrous organization (<i>p. 390</i>)	Holacracy (<i>p. 380</i>)	Organizational design (<i>p. 381</i>)
Centralization (<i>p. 385</i>)	Inertia (<i>p. 382</i>)	Organizational structure (<i>p. 384</i>)
Exploitation (<i>p. 390</i>)	Input controls (<i>p. 408</i>)	Output controls (<i>p. 408</i>)
Exploration (<i>p. 390</i>)	Matrix structure (<i>p. 394</i>)	Simple structure (<i>p. 387</i>)
Formalization (<i>p. 384</i>)	Mechanistic organization (<i>p. 385</i>)	Span of control (<i>p. 385</i>)
Founder imprinting (<i>p. 403</i>)	Multidivisional structure (M-form) (<i>p. 391</i>)	Specialization (<i>p. 384</i>)
Functional structure (<i>p. 388</i>)	Open innovation (<i>p. 398</i>)	Strategic control-and-reward systems (<i>p. 407</i>)

DISCUSSION QUESTIONS

1. Why is it important for an organization to have alignment between its strategy and structure?
2. The chapter describes the role of culture in the successful implementation of strategy. Consider an employment experience of your own or of someone you have observed closely (e.g., a family member). Describe to the best of your ability the values, norms, and artifacts of the organization. What was the socialization process of embedding the culture? Do you consider this to be an example of an effective culture for contributing to the organization's competitive advantage? Why or why not?
3. Strategy Highlight 11.1 discusses the informal organizational structure of W.L. Gore & Associates. Go to the firm's website (www.gore.com) and review the company's product scope. What commonalities across the products would likely be enhanced by flexible cross-functional teams? Next look in the "about Gore" section (under the menu) of the website. What would be your expectations of the type of control and rewards systems found at W.L. Gore?

ETHICAL/SOCIAL ISSUES

1. As noted in Chapter 5, many public firms are under intense pressure for short-term (such as quarterly) financial improvements. How might such pressure, in combination with output controls, lead to unethical behaviors?
2. Cultural norms and values play a significant role in all organizations, from businesses in the economic sector to religious, political, and sports organizations. Strong organizational cultures can have many benefits, such as those described in the Zappos example. However, sometimes a strong organizational culture is less positive. Vince Lombardi, renowned coach of the Green Bay Packers, is often quoted as saying, "Winning isn't everything; it's

the only thing.” Many sports teams from junior sports to professional sports have either explicitly or implicitly touted this attitude as exemplary. Others, however, argue that this attitude is what’s wrong with sports and leads to injury, minor misbehavior, and criminal behavior. It encourages players to do whatever it takes to win—from tripping a player or other unsportsmanlike conduct during middle-school sports to throwing a game as part of gambling. Name other examples of organizational culture leading to business failure, criminal behavior, or civil legal actions.

When a player hears the message as “any action will be tolerated as long as you are winning,” there can be serious consequences on and

off the field. How could leaders of sports organizations communicate the will to win and develop the necessary skills while maintaining ethical behavior? Think of examples of coaches who coaxed players to play by the rules and maintain high personal ethical standards. What other socialization experiences could a coach use? What is the role of team leaders in encouraging high ethical standards while building the desire to win?

3. What makes some strong cultures helpful in gaining and sustaining a competitive advantage, while other strong cultures are a liability to achieving that goal?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Your classmates are a group of friends who have decided to open a small retail shop. The team is torn between two storefront ideas. The first idea is to open a high-end antique store selling household items used for decoration in upscale homes. Members of the team have found a location in a heavily pedestrian area near a local coffee shop. The store would have many items authenticated by a team member’s uncle, who is a certified appraiser.

In discussing the plan, however, two group members suggest shifting to a drop-off store for online auctions such as eBay. In this “reverse logistics” business model, customers drop off items they want to sell, and the retail store does all the logistics involved—listing and selling the items on eBay or Amazon, and then shipping them to buyers—for a percentage of the sales price. They suggest that a quick way to get started is to become a franchisee for a group such as “I Sold It” (www.877isoldit.com).

1. What is the business strategy for each of these two store concepts?
2. How would the organizational structure be different for the concepts?
3. What would likely be the cultural differences in the two store concepts?
4. How would the control-and-reward systems be different?

//// Small Group Exercise 2 (Ethical/Social Issues)

The chapter describes Daniel Pink’s ROWE theory of motivation, in which he argued that the most powerful motivation occurs when there is an interest in the work and the work itself has meaning. Intrinsic motivation is highest when an employee has *autonomy* (about what to do), *mastery* (how to do it), and *purpose* (why to do it). Assume your group has been asked by your university to brainstorm ways that the university might apply the ROWE theory. Discuss whether you would be more motivated and better educated if you had more autonomy in designing your program of study, could determine the best way for you to learn and gain mastery, and could develop your own statement of purpose as to why you were pursuing a particular program of study.

1. How might this change the university’s allocation of resources (e.g., would more trained advisers and career counselors be required, and how would they be evaluated)?
2. If large numbers of students decided they would learn some of the core materials best by taking an online course, how might this affect the university’s revenue stream? How might this change the way professors teach courses?
3. Have each group member explain how this approach might change his or her program of study.
4. Consider the potential pitfalls of such an approach and how these might be addressed.

mySTRATEGY

For What Type of Organization Are You Best-Suited?

As noted in the chapter, firms can have very distinctive cultures. Recall that Zappos has a standing offer to pay any new hire one month's salary to quit the company after orientation. Zappos makes this offer to help ensure that those who stay with the company are comfortable in its "create fun and a little weirdness" environment.

You may have taken a personality test such as Myers-Briggs or The Big Five. These tests may be useful in gauging compatibility of career and personality types. They are often available for both graduate and undergraduate students at university career placement centers. In considering the following questions, think about your next job and your longer-term career plans.

1. Review Exhibit 11.11 and circle the organizational characteristics you find appealing. Cross out those factors you think you would not like. Do you find a trend toward either the mechanistic or organic organization?
2. Have you been in school or work situations in which your values did not align with those of your peers or colleagues? How did you handle the situation? Are there certain values or norms important enough for you to consider as you look for a new job?
3. As you consider your career after graduation, which control-and-reward system would you find most motivating? Is this different from the controls used at some jobs you have had in the past? How do you think you would perform in a holacracy such as Zappos?

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CHAPTER 12 Corporate Governance and Business Ethics

Chapter Outline

- 12.1** The Shared Value Creation Framework
 - Public Stock Companies and Shareholder Capitalism*
 - Creating Shared Value*
- 12.2** Corporate Governance
 - Agency Theory*
 - The Board of Directors*
 - Other Governance Mechanisms*
- 12.3** Strategy and Business Ethics
 - Bad Apples vs. Bad Barrels*
- 12.4** Implications for Strategic Leaders

Learning Objectives

- LO 12-1** Describe the shared value creation framework and its relationship to competitive advantage.
- LO 12-2** Explain the role of corporate governance.
- LO 12-3** Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.
- LO 12-4** Evaluate the board of directors as the central governance mechanism for public stock companies.
- LO 12-5** Evaluate other governance mechanisms.
- LO 12-6** Explain the relationship between strategy and business ethics.

Uber: Most Ethically Challenged Tech Company?

UBER'S VALUATION REACHED \$70 billion in 2017 and became the most valuable private startup ever. Yet in the process of achieving such success, Uber's unethical, if not illegal, activity generated controversy after controversy. Before we look more closely at those ethical issues, we need to understand the business success that could have tempted Uber to engage in ethical shortcuts.

RECORD-BREAKING GROWTH

In comparison, Facebook took seven years to reach a valuation of \$50 billion for a private, venture-capital-backed firm; Uber only five. If we compare Uber with car rental giant Hertz—with some 150 locations, a fleet of 500,000 cars, and about 30,000 employees—it's astounding to learn that Hertz reaches only about 1 percent of Uber's valuation!

Uber reached this astronomical valuation because it successfully expanded both in the United States and globally to some 500 cities in 70 countries. As a powerful platform business, Uber's popularity grows exponentially, as it already transports millions of riders daily and continues to expand rapidly here and abroad. Although Uber is still losing money as it continues to subsidize customer fares, its revenues race ahead, from \$400 million in 2014 to more than \$8 billion in 2017.

ETHICALLY CHALLENGED?

Trailing Uber's meteoric rise are multiple lawsuits and accusations, often tied directly to decisions and actions by its co-founder and now former CEO, Travis Kalanick. Consider just some of the incidents and issues in the company's short history:

- **Early disregard for laws, rules, and regulations.** Within months of its San Francisco launch, the local Metro Transit Authority and the state Public Utilities Commission had to order Uber to cease and desist. They called out Uber as an unlicensed and illegal taxi service. Similar injunctions followed in major markets, including New York City, Los Angeles, Toronto, Paris, London, Berlin, and Delhi. Uber's response? The company ignored all such warnings.
- **Dynamic pricing.** Unlike the taxi industry, in which pricing is fixed by regulation, Uber uses dynamic pricing, following the model of airlines, hotels, and other



Travis Kalanick, Uber's co-founder and former CEO, came to be seen as too much of a liability for the comfort of major Uber investors and was pressured to resign the key post. The relentlessly ambitious and combative entrepreneur was well aware of his reputation, which he described during a speech celebrating Uber's fifth anniversary: "I realize that I can come off as a somewhat fierce advocate for Uber. I also realize that some have used a different 'a'-word to describe me."¹

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industries. Uber's fares go up or down based on real-time supply and demand. During a snowstorm or on New Year's Eve, short Uber rides can cost hundreds of dollars! Kalanick argued that surge pricing efficiently matches supply and demand. But many Uber users rant online against the practice and call it price gouging.

- **Punking the competition.** Lyft, the competing ride-share company, accused Uber of ordering over 5,000 rides from Lyft, and then canceling, so Lyft drivers lost business from legitimate rides.
- **Punking their own drivers.** Reportedly Uber told its drivers in New York that they could not work for both Uber and Lyft because of city regulations. No such regulations exist.
- **Poaching drivers.** As part of Uber's secret Operation SLOG (Supplying Long-term Operations Growth), accusers say Uber brand ambassadors actively target successful drivers from Lyft and other competitors to defect.
- **Poisoning competitor's well.** Startups live or die based on access to capital. Kalanick reportedly poisoned Lyft's efforts to raise venture capital, telling investors, "Before you decide whether you want to invest in [Lyft], just make sure you know that we are going to be fund-raising immediately after."²
- **Attacking critics.** In 2014, Uber senior executive Emil Michael suggested spending \$1 million to hire private

investigators to dig up dirt on journalists who wrote damaging pieces on Uber, with particular focus on Sarah Lacy, of tech blog PandoDaily. When the remarks became public, Michael apologized, Kalanick decried the attempt, but Michael was not disciplined. (In June 2017, in the wake of Kalanick's forced resignation, Michael also resigned.)

- **Tech transfer by stealth.** In 2015, Uber opened an Advanced Tech Center in Pittsburgh to develop autonomous cars and sophisticated mapping services. Funding research at Carnegie Mellon University's National Robotics Engineering Center (NREC) brought Uber access to the university's scientists. A few months later, Uber poached entire NREC research teams with signing bonuses, twice the salaries, and stock options. The NREC was left a shell, with its entire future in question.
- **Allegations of sexual harassment and gender discrimination.** In 2017, a blog post by a former Uber engineer went viral. It alleged rampant sexual harassment, persistent mistreatment of female employees, and the company's failure to respond to complaints. The former employee said that women engineers in her work group dropped from 25 percent to as low as 3 percent within a year because of the hostile work environment. She also claimed managers downgraded her performance review for reporting a supervising manager for harassment.
- **Slow response.** It took public outcry for Kalanick to act on the allegations of sexual harassment, although once he took action, he went big. He hired former U.S. Attorney General Eric Holder to lead an internal investigation, working with Arianna Huffington, Uber's only female board member.
- **Operation Greyball.** Also in 2017, *The New York Times* exposed Uber's use of stealth technology for a number of years to foil law enforcement and regulators investigating Uber and its drivers. In a secret operation code-named Greyball, Uber programmed its software to set up GPS rings around government offices and track low-cost phones and credit cards linked to government accounts. Thus, when law enforcement officers posed as Uber customers, Uber showed them dummy screens with fake Uber cars moving, none of which would stop and pick them up. Greyball was deployed worldwide, especially in cities where Uber was outlawed.
- **Kalanick caught on video.** Kalanick did not realize he was being filmed by a dashboard cam when an Uber driver complained about recent fare cuts. As Kalanick left the car, he told the driver, "You know what, some people don't like to take responsibility for their own sh**," and slammed the door. The driver uploaded the video to social media, where it went viral.

- **Waymo lawsuit.** Waymo, a unit of Alphabet (Google's parent company), is suing Uber for stealing Waymo's proprietary self-driving technology. Uber acquired the autonomous-vehicle startup Otto, which was founded by Anthony Levandowski, but at the same time Levandowski was working for Waymo on its autonomous-vehicle program. Waymo claims Levandowski stole more than 14,000 proprietary files. The stakes are high because experts predict that only one or two technology standards will prevail for self-driving technology. Waymo wants to become the default operating system for self-driving cars with its proprietary technology.

FORCED TO RESIGN

Such issues came to a head in mid-2017. In May, the results of the Holder investigation, along with 50 recommendations, were delivered to the Uber board. On June 13, Kalanick took an indefinite leave of absence, citing the recent death of his mother and his need to deal with that personal issue. And then June 21, responding to a letter from key investors, he formally resigned. The investors had expressed no confidence in Kalanick's ability to continue to lead the company he co-founded.

A Reputation to Live Down. You could say the company developed a reputation to live down. Uber's ethical challenges were called out publicly throughout its rise, and as early as 2014, venture capitalist Peter Thiel called Uber the "most ethically challenged company in Silicon Valley."³ Of course, Thiel, the billionaire co-founder of PayPal and Palantir (a data analytics company), is also an investor in Lyft, Uber's main competitor. Lyft (featured in ChapterCase 9) has a valuation of only \$7.5 billion, a bit over 10 percent of Uber's.

Its Own Worst Rival. Echoing Thiel's assessment, *The Wall Street Journal (WSJ)* argued Uber itself—rather than Lyft or old-line taxi and limo services—is its own biggest threat, thereby functioning as its own biggest rival. The competitive tactics and comments by Uber executives and constant scandals surrounding Kalanick are harming the company's reputation and becoming a liability, the *WSJ* argues.

DISASTER AVERTED?

Whether symbolic or substantive, Kalanick's resignation may mark the point at which Uber embraced the ethical standards required to thrive in the big leagues and for the long term. Kalanick's resignation may come to be seen as the step that saved Uber from itself.⁴

You will learn more about Uber by reading this chapter; related questions appear in "ChapterCase 12 / Consider This. . . ."

THE UBER CHAPTERCASE illustrates how intricate and intertwined business ethics issues and competitive advantage can be. With close to \$70 billion in valuation, Uber is riding high as the world's most valuable private start-up firm ever. Its huge cash pile fuels its rapid expansion in the United States and abroad. It allows Uber to subsidize fares and to attract more drivers to its platform. All this is done to create network effects based on a large installed base of Uber drivers and users. In what is likely to be a winner-take-all market, Uber is planning to be the winner in mobile, on-demand logistics. In a future history of Uber, 2017 might be seen as the year in which the company, guided by major investors and its board, saved Uber from itself.

In this chapter, we wrap up our discussion of strategy implementation and close the circle in the AFI framework by studying two important areas: corporate governance and business ethics. We begin with the *shared value creation framework* to illuminate the link between strategic management, competitive advantage, and society more fully. We then discuss effective *corporate-governance* mechanisms to direct and control the enterprise, which a firm must put in place to ensure pursuit of its intended goals. Next, we study *business ethics*, which enable strategic leaders to think through complex decisions in an increasingly dynamic, interdependent, and global marketplace. The vignettes in the ChapterCase documenting controversial decisions, tactics, and statements by Uber highlight the link between business ethics and competitive advantage. We conclude with *Implications for Strategic Leaders*.

12.1 The Shared Value Creation Framework

The shared value creation framework provides guidance to managers about how to reconcile the economic imperative of gaining and sustaining competitive advantage with corporate social responsibility (introduced in Chapter 2).⁵ It helps managers create a larger pie that benefits both shareholders and other stakeholders. To develop the shared value creation framework, though, we first must understand the role of the public stock company.

LO 12-1

Describe the shared value creation framework and its relationship to competitive advantage.

PUBLIC STOCK COMPANIES AND SHAREHOLDER CAPITALISM

The public stock company is an important institutional arrangement in modern, free market economies. It provides goods and services as well as employment, pays taxes, and increases the standard of living. There exists an implicit contract based on trust between society and the public stock company. Society grants the right to incorporation, but in turn expects companies to be good citizens by adding value to society.

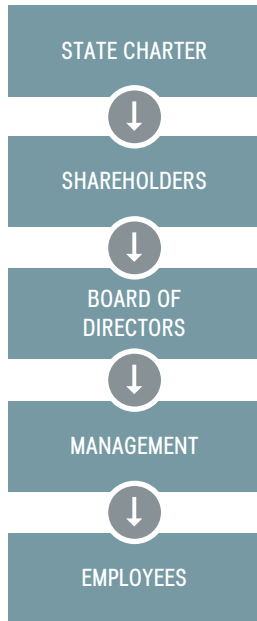
To fund future growth, companies frequently need to go public. Uber, featured in the ChapterCase, is one of the few companies that achieved a huge valuation before an initial public offering. Private start-up companies valued at a billion dollars or more are called *unicorns*, because at one time they seemed as rare as the mythical beast. But their elusiveness has changed. The tech sector now has the lion's share: more than 160 unicorns valued at \$1 billion or more, for a total of \$615 billion.⁶ The top five most valuable private startups (as of the summer of 2017) are Uber, Didi Chuxing (Chinese ride-hailing



In capital markets, private companies that achieve a valuation of \$1 billion or greater were once rare enough to be called unicorns.
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EXHIBIT 12.1

The Public Stock Company: Hierarchy of Authority



company and mobile logistics network, similar to Uber), Xiaomi (Chinese smartphone maker), Airbnb, and Palantir. These new ventures may eventually go public such as did Snap (2017), Twitter (2013), Facebook (2012), and LinkedIn (2011). As long as these unicorns remain private, however, they do not have to follow the stringent financial reporting and auditing requirements that public stock companies do. Consider that there may be a connection between firm structure and the degree that it integrates ethics. Not needing to expose themselves to as much public scrutiny as a publicly traded company also allows unicorns such as Uber to push the envelope in their legal and ethical business practices. A potential downside is, however, that a track record of ethics and legal problems may prevent a successful initial public offering (IPO) in the future.

Exhibit 12.1 depicts the levels of hierarchy within a public stock company. The state or society grants a charter of incorporation to the company's shareholders—its legal owners, who own stock in the company. The shareholders appoint a board of directors to govern and oversee the firm's management. The managers hire, supervise, and coordinate employees to manufacture products and provide services. The public stock company enjoys four characteristics that make it an attractive corporate form:⁷

1. *Limited liability for investors.* This characteristic means the shareholders who provide the risk capital are liable only to the capital specifically invested, and not for other investments they may have made or for their personal wealth. Limited liability encourages investments by the wider public and entrepreneurial risk-taking.
2. *Transferability of investor ownership* through the trading of shares of stock on exchanges such as the New York Stock Exchange (NYSE) and NASDAQ,⁸ or exchanges in other countries. Each share represents only a minute fraction of ownership in a company, thus easing transferability.
3. *Legal personality*—that is, the law regards a non-living entity such as a for-profit firm as similar to a person, with legal rights and obligations. Legal personality allows a firm's continuation beyond the founder or the founder's family.
4. *Separation of legal ownership and management control.*⁹ In publicly traded companies, the stockholders (the principals, represented by the board of directors) are the legal owners of the company, and they delegate decision-making authority to professional managers (the agents).

The public stock company has been a major contributor to value creation since its inception as a new organizational form more than a hundred years ago. Michael Porter and others, however, argue that many public companies have defined value creation too narrowly in terms of financial performance.¹⁰ This in turn has contributed to some of the *black swan events* discussed in Chapter 2, such as large-scale accounting scandals and the global financial crisis. Managers' pursuit of strategies that define value creation too narrowly may have negative consequences for society at large, as evidenced during the global financial crisis. This narrow focus has contributed to the loss of trust in the corporation as a vehicle for value creation, not only for shareholders but also other stakeholders and society.

Nobel laureate Milton Friedman stated his view of the firm's social obligations: "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."¹¹ This notion is often captured by the term **shareholder capitalism**. According to this perspective, shareholders—the providers of the necessary risk capital and the legal owners of public companies—have the most legitimate claim on profits. When introducing the notion of *corporate social responsibility* (CSR) in Chapter 2, though, we noted that a firm's obligations frequently go beyond the economic responsibility to increase profits, extending to ethical and philanthropic expectations that society has of the business enterprise.¹²

shareholder capitalism
Shareholders—the providers of the necessary risk capital and the legal owners of public companies—have the most legitimate claim on profits.

A survey that measured attitudes toward business responsibility in various countries provides more insights into this debate and how opinions may vary across the globe. The survey asked the top 25 percent of income earners holding a university degree in each country surveyed whether they agree with Milton Friedman's philosophy that "the social responsibility of business is to increase its profits."¹³ The results, displayed in Exhibit 12.2, revealed intriguing national differences. The United Arab Emirates (UAE), a small and business-friendly federation of seven emirates, had the highest level of agreement, at 84 percent. Roughly two-thirds agreed in the Asian countries of Japan, India, South Korea, and Singapore, which completed the top five in the survey.

The countries where the fewest people agreed with Friedman's philosophy were China, Brazil, Germany, Italy, and Spain; fewer than 40 percent of respondents in those countries supported an exclusive focus on shareholder capitalism. Although they have achieved a high standard of living, European countries such as Germany have tempered the free market system with a strong social element, leading to so-called *social market economies*. The respondents from these countries seemed to be more supportive of a *stakeholder strategy* approach to business. Some critics, however, would argue that too strong a focus on the social dimension contributed to the European debt crisis because sovereign governments such as Greece, Italy, and Spain took on unsustainable debt levels to fund social programs such as early retirement plans, government-funded health care, and so on. The United States placed roughly in the middle of the continuum—a bit more than half (56 percent) of U.S. respondents subscribed to Friedman's philosophy.

CREATING SHARED VALUE

In contrast to Milton Friedman, Porter argues that executives should not concentrate exclusively on increasing firm profits. Rather, an effective strategic leader should focus on creating *shared value*, a concept that involves creating economic value for shareholders while also creating social value by addressing society's needs and challenges. He argues that managers need to reestablish the important relationship between superior firm performance and societal progress. This dual point of view, Porter argues, will not only allow

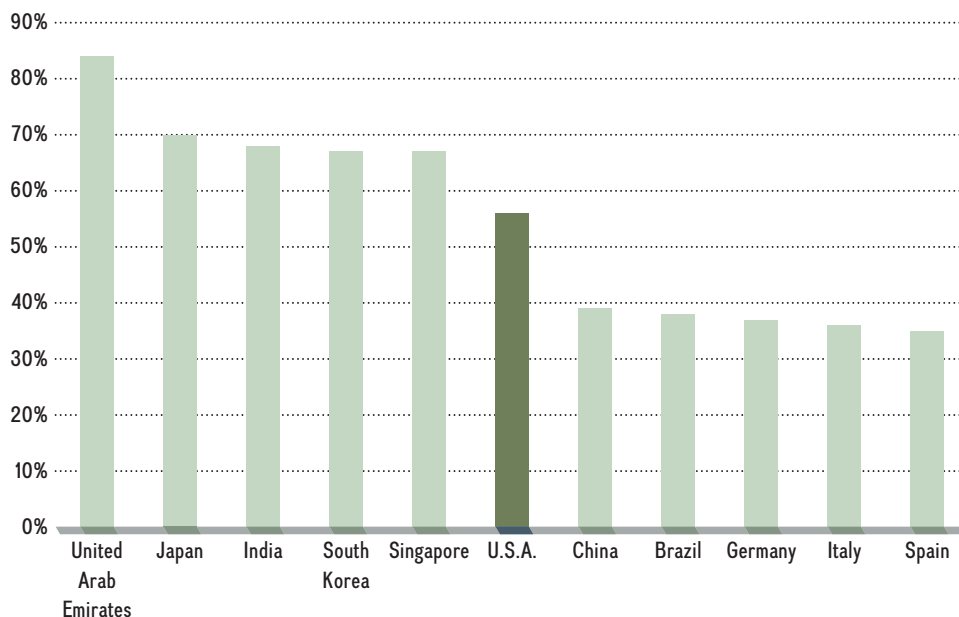


EXHIBIT 12.2

Global Survey of Attitudes toward Business Responsibility

The bar chart indicates the percentage of members of the "informed public" who "strongly agree/somewhat agree" with Milton Friedman's philosophy, "the social responsibility of business is to increase its profits."

SOURCE: Depiction of data from Edelman's, Trust Barometer, 2011 as included in "Milton Friedman goes on tour," *The Economist*, January 27, 2011.

shared value creation framework A model proposing that managers have a dual focus on shareholder value creation and value creation for society.

companies to gain and sustain a competitive advantage but also reshape capitalism and its relationship to society.

The **shared value creation framework** proposes that managers maintain a dual focus on shareholder value creation and value creation for society. It recognizes that markets are defined not only by economic needs but also by societal needs. It also advances the perspective that *externalities* such as pollution, wasted energy, and costly accidents actually create *internal costs*, at least in lost reputation if not directly on the bottom line. Rather than pitting economic and societal needs in a trade-off, Porter suggests that the two can be reconciled to create a larger pie. The shared value creation framework seeks to enhance a firm's competitiveness by identifying connections between economic and social needs, and then creating a competitive advantage by addressing these business opportunities.

GE, for example, has strengthened its competitiveness by creating a profitable business with its "green" *Ecomagination* initiative. Ecomagination is GE's strategic initiative to provide cleaner and more efficient sources of energy, provide abundant sources of clean water anywhere in the world, and reduce emissions.¹⁴ Jeffrey Immelt, GE's former CEO, would often say, "Green is green,"¹⁵ meaning that addressing ecological needs offers the potential of gaining and sustaining a competitive advantage for GE. Through applying strategic innovation, GE is providing solutions for some tough environmental challenges, while driving company growth at the same time. Ecomagination solutions and products allow GE to increase the perceived value it creates for its customers while lowering costs to produce and deliver the "green" products and services. Ecomagination allows GE to solve the trade-off between increasing value creation and lowering costs. This in turn enhances GE's economic value creation and its competitive advantage.

Moreover, Ecomagination products and services also create value for society in terms of reducing emissions and lowering energy consumption, among other benefits. In 2016, "green" energy obtained from renewables (wind, solar, water, etc.) has for the first time surpassed coal in terms of electricity capacity additions. More than half of new energy capacity now comes from renewables and is estimated to be two-thirds within the next five years. In its sustainability report, GE says, "Investing in clean energy has proven good for business, job creation, the economy and the world." Since launched in 2005, GE has invested \$20 billion in Ecomagination and reported in 2017 that revenues from this strategic initiative alone have reached \$270 billion to date.¹⁶

To ensure that managers can reconnect economic and societal needs, Michael Porter recommends that managers focus on three things within the shared value creation framework:¹⁷

1. **Expand the customer base to bring in nonconsumers** such as those at the *bottom of the pyramid*—the largest but poorest socioeconomic group of the world's population. The bottom of the pyramid in the global economy can yield significant business opportunities, which—if satisfied—could improve the living standard of the world's poorest. Muhammad Yunus, Nobel Peace Prize winner, founded Grameen Bank in Bangladesh to provide small loans (termed *microcredit*) to impoverished villagers, who used the funding for entrepreneurial ventures that would help them climb out of poverty. Other businesses have also found profitable opportunities at the bottom of the pyramid. In India, Arvind Ltd. offers jeans in a ready-to-make kit that costs only a fraction of the high-end Levi's. The Tata group sells its Nano car for around 150,000 rupees (about \$2,500), enabling more Indian families to move from mopeds to cars and potentially adding up to a substantial business.
2. **Expand traditional internal firm value chains to include more nontraditional partners** such as *nongovernmental organizations* (NGOs). NGOs are nonprofit organizations that pursue a particular cause in the public interest and are independent of any governments. Habitat for Humanity and Greenpeace are examples of NGOs.

3. **Focus on creating new *regional clusters*** such as Silicon Valley in the United States; Electronic City in Bangalore, India; and Chilecon Valley in Santiago, Chile.

In line with *stakeholder theory* (discussed in Chapter 2), Porter argues that these strategic actions will lead to a larger pie of revenues and profits that can be distributed among a company's stakeholders. General Electric, for example, recognizes a convergence between shareholders and stakeholders to create shared value. It states in its governance principles: "Both the board of directors and management recognize that the long-term interests of shareowners are advanced by responsibly addressing the concerns of other stakeholders and interested parties, including employees, recruits, customers, suppliers, GE communities, government officials, and the public at large."¹⁸ To ensure that convergence takes place, companies need effective governance mechanisms, which we discuss next.

12.2 Corporate Governance

Corporate governance concerns the mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.¹⁹ Corporate governance is about checks and balances and about asking the tough questions at the right time. The accounting scandals of the early 2000s and the global financial crisis of 2008 and beyond got so out of hand because the enterprises involved did not practice effective corporate governance. As discussed in the ChapterCase, some observers question whether Uber has effective corporate-governance mechanisms in place, or whether its ethically and legally questionable competitive tactics and decisions are part of a larger intended strategy to first dominate the mobile, on-demand logistics business and then to address any remaining stakeholder grievances.

Corporate governance attempts to address the *principal-agent problem* (introduced in Chapter 8), which can occur any time an agent performs activities on behalf of a principal.²⁰ This problem can arise whenever a principal delegates decision making and control over resources to agents, with the expectation that they will act in the principal's best interest.

We mentioned earlier that the separation of ownership and control is one of the major advantages of the public stock companies. This benefit, however, is also the source of the principal-agent problem. In publicly traded companies, the stockholders are the legal owners of the company, but they delegate decision-making authority to professional managers. The conflict arises if the agents pursue their own personal interests, which can be at odds with the principals' goals. For their part, agents may be more interested in maximizing their total compensation, including benefits, job security, status, and power. Principals desire maximization of total returns to shareholders.

The risk of opportunism on behalf of agents is exacerbated by *information asymmetry*: The agents are generally better informed than the principals. Exhibit 12.3 depicts the principal-agent relationship.

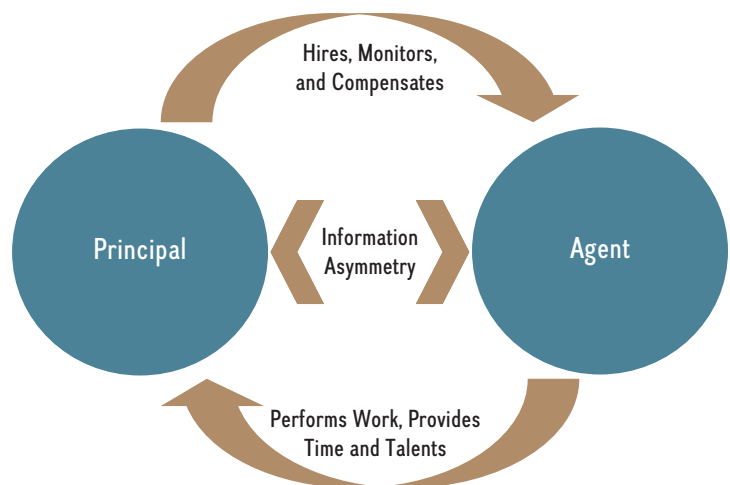
Managers, executives, and board members tend to have access to *private information* concerning important company developments that outsiders, especially investors, are

LO 12-2

Explain the role of corporate governance.

corporate governance
A system of mechanisms to direct and control an enterprise in order to ensure that it pursues its strategic goals successfully and legally.

EXHIBIT 12.3 / The Principal-Agent Problem



not privy to. Often this informational advantage is based on timing—insiders are the first to learn about important developments before the information is released to the public. Although possessing insider information is not illegal and indeed is part of an executive's job, what *is* illegal is acting upon it through trading stocks or passing on the information to others who might do so. Insider-trading cases, therefore, provide an example of egregious exploitation of information asymmetry. The hedge fund Galleon Group (holding assets worth \$7 billion under management at its peak) was engulfed in an insider-trading scandal involving private information about important developments at companies such as Goldman Sachs, Google, IBM, Intel, and P&G.²¹ Galleon Group's founder, Raj Rajaratnam, the mastermind behind a complex network of informants, was sentenced to 11 years in prison and fined more than \$150 million. In one instance, an Intel manager had provided Rajaratnam with internal Intel data such as orders for processors and production runs. These data indicated that demand for Intel processors was much higher than analysts had expected. Galleon bought Intel stock well before this information was public to benefit from the anticipated share appreciation.

In another instance, Rajaratnam benefited from insider tips provided by Rajat Gupta, a former McKinsey chief executive who served on Goldman Sachs' board. Often within seconds after a Goldman Sachs board meeting ended, Gupta called Rajaratnam. In one of these phone calls, Gupta revealed the impending multibillion-dollar liquidity injection by Warren Buffett into Goldman Sachs during the midst of the global financial crisis. This information allowed the Galleon Group to buy Goldman Sachs shares before the official announcement about Buffett's investment was made, profiting from the subsequent stock appreciation. In another call, Gupta informed Rajaratnam that the investment bank would miss earnings estimates. Based on this insider information, the Galleon Group was able to sell its holdings in Goldman Sachs stock before the announcement, avoiding a multimillion-dollar loss.²²

Information asymmetry also can breed *on-the-job consumption*, perquisites, and excessive compensation. Although use of company funds for golf outings, resort retreats, professional sporting events, or elegant dinners and other entertainment is an everyday manifestation of on-the-job consumption, other forms are more extreme. Dennis Kozlowski, former CEO of Tyco, a diversified conglomerate, used company funds for his \$30 million New York City apartment (the shower curtain alone was \$6,000) and for a \$2 million birthday party for his second wife.²³ John Thain, former CEO of Merrill Lynch, spent \$1.2 million of company funds on redecorating his office, while he demanded cost cutting and frugality from his employees.²⁴ Such uses of company funds, in effect, mean that shareholders pay for those items and activities. Thain also allegedly requested a bonus of up to \$30 million in 2009 despite Merrill Lynch having lost billions of dollars and being unable to continue as an independent company. Merrill Lynch was later acquired by Bank of America in a fire sale.

LO 12-3

Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

AGENCY THEORY

The principal–agent problem is a core part of **agency theory**, which views the firm as a nexus of legal contracts.²⁵ In this perspective, corporations are viewed as a set of legal contracts between different parties. Conflicts that may arise are to be addressed in the legal realm. Agency theory finds its everyday application in employment contracts, for example.

Besides dealing with the relationship between shareholders and managers, principal–agent problems also cascade down the organizational hierarchy (shown in Exhibit 12.3). Senior executives, such as the CEO, face agency problems when they delegate authority of strategic business units to general managers.

One incident at Uber illustrates the principal–agent problem. Uber's office in Lyon, France, ran a sexist ad campaign that promised rides with “avions de chasse” as drivers,

agency theory A theory that views the firm as a nexus of legal contracts.

which is French for fighter jets, but colloquially it means “hot chicks.” The ads were accompanied by revealing photos of female models. Uber headquarters canceled the ad campaign and apologized for the “clear misjudgment by the local team.” Uber headquarters staff in the United States, therefore, claimed that the sexist ad campaign launched by its French office was based on an agency problem, explaining it as a “clear misjudgment by the local team.” The local team, however, thought this type of ad campaign would serve Uber well in France.

Employees who perform the actual operational labor are agents who work on behalf of the managers. Such frontline employees often enjoy an informational advantage over management. They may tell their supervisor that it took longer to complete a project or serve a customer than it actually did, for example. Some employees may be tempted to use such informational advantage for their own self-interest (e.g., spending time on Facebook during work hours, watching YouTube videos, or using the company’s computer and internet connection for personal business).

The lawsuit between Waymo and Uber (detailed in the ChapterCase) illustrates the thorny issues that arise out of the inherent principal–agent problem in employment relationships.²⁶ In this case, Anthony Levandowski, the engineer at the heart of the lawsuit between Waymo and Uber, is alleged to have set up his autonomous-vehicle company, Otto, while still working at Waymo as a front to siphon off trade secrets and proprietary technology from his employer. Shortly after Levandowski left Waymo formally, Uber acquired his start-up company for close to \$700 million. Waymo alleges that Levandowski set up Otto to steal trade secrets and proprietary designs, and to turn around and use this knowledge to advance self-driving technology at Uber, which acquired Otto later in 2016. Waymo, therefore, alleges that Levandowski and Uber not only acted opportunistically but also illegally. This is a stark turnaround from the earlier close relationship between Alphabet and Uber. In particular, Google Ventures, Alphabet’s venture capital unit, had made a \$200 million investment in the fledgling ride-hailing service in 2013. Alphabet’s chief legal counsel was also a board member at Uber. He resigned from Uber’s board one week after Uber acquired Otto.

The managerial implication of agency theory relates to the management functions of organization and control: The firm needs to design work tasks, incentives, and employment contracts and other control mechanisms in ways that minimize opportunism by agents. Such governance mechanisms are used to align incentives between principals and agents. These mechanisms need to be designed in such a fashion as to overcome two specific agency problems: *adverse selection* and *moral hazard*.

ADVERSE SELECTION. In general, **adverse selection** occurs when information asymmetry increases the likelihood of selecting inferior alternatives. In principal–agent relationships, for example, adverse selection describes a situation in which an agent misrepresents his or her ability to do the job. Such misrepresentation is common during the recruiting process. Once hired, the principal may not be able to accurately assess whether the agent can do the work for which he or she is being paid. The problem is especially pronounced in team production, when the principal often cannot ascertain the contributions of individual team members. This creates an incentive for opportunistic employees to free-ride on the efforts of others.

adverse selection A situation that occurs when information asymmetry increases the likelihood of selecting inferior alternatives.

MORAL HAZARD. In general, **moral hazard** describes a situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs accrue to the other party. For example, bailing out homeowners from their mortgage obligations or bailing out banks from the consequences of undue risk-taking in lending are examples of moral hazard. The costs of default are rolled over to society. Knowing that there is a high probability of being bailed out (“too big to fail”) increases moral hazard. In this scenario, any profits remain private, while losses become public.

moral hazard A situation in which information asymmetry increases the incentive of one party to take undue risks or shirk other responsibilities because the costs incur to the other party.

In the principal–agent relationship, moral hazard describes the difficulty of the principal to ascertain whether the agent has really put forth a best effort. In this situation, the agent is *able* to do the work but may decide not to do so. For example, a company scientist at a biotechnology company may decide to work on his own research project, hoping to eventually start his own firm, rather than on the project he was assigned.²⁷ While working on his own research on company time, she might also use the company’s laboratory and technicians. Given the complexities of basic research, it is often challenging, especially for nonscientist principals, to ascertain which problem a scientist is working on.²⁸ To overcome these principal–agent problems, firms put several governance mechanisms in place. We shall discuss several of them next, beginning with the board of directors.

THE BOARD OF DIRECTORS

LO 12-4

Evaluate the board of directors as the central governance mechanism for public stock companies.

board of directors The centerpiece of corporate governance, composed of inside and outside directors who are elected by the shareholders.

inside directors Board members who are generally part of the company’s senior management team; appointed by shareholders to provide the board with necessary information pertaining to the company’s internal workings and performance.

outside directors Board members who are not employees of the firm, but who are frequently senior executives from other firms or full-time professionals.

The shareholders of public stock companies appoint a **board of directors** to represent their interests (see Exhibit 12.1). The board of directors is the centerpiece of corporate governance in such companies. The shareholders’ interests, however, are not uniform. The goals of some shareholders, such as institutional investors (e.g., retirement funds, governmental bodies, and so on), are generally the long-term viability of the enterprise combined with profitable growth. Long-term viability and profitable growth should allow consistent dividend payments and result in stock appreciation over time. The goals of other shareholders, such as hedge funds, are often to profit from short-term movements of stock prices. These more proactive investors often demand changes in a firm’s strategy, such as spinning out certain divisions or splitting up companies into parts to enhance overall performance. Votes at shareholder meetings, generally in proportion to the amount of ownership, determine whose representatives are appointed to the board of directors.

The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors who are elected by the shareholders:²⁹

- **Inside directors** are generally part of the company’s senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO). They are appointed by shareholders to provide the board with necessary information pertaining to the company’s internal workings and performance. Without this valuable inside information, the board would not be able to effectively monitor the firm. As senior executives, however, inside board members’ interests tend to align with management and the CEO rather than the shareholders.
- **Outside directors**, on the other hand, are not employees of the firm. They frequently are senior executives from other firms or full-time professionals, who are appointed to a board and who serve on several boards simultaneously. Given their independence, they are more likely to watch out for the interests of shareholders.

The board is elected by the shareholders to represent their interests. Each director has a *fiduciary responsibility*—a legal duty to act solely in another party’s interests—toward the shareholders because of the trust placed in him or her. Prior to the annual shareholders’ meeting, the board proposes a slate of nominees, although shareholders can also directly nominate director candidates. In general, large institutional investors support their favored candidates through their accumulated proxy votes. The board members meet several times a year to review and evaluate the company’s performance and to assess its future strategic plans as well as opportunities and threats. In addition to general strategic oversight and guidance, the board of directors has other, more specific functions, including:

- Selecting, evaluating, and compensating the CEO. The CEO reports to the board. Should the CEO lose the board's confidence, the board may fire him or her.
- Overseeing the company's CEO succession plan.
- Providing guidance to the CEO in the selection, evaluation, and compensation of other senior executives.
- Reviewing, monitoring, evaluating, and approving any significant strategic initiatives and corporate actions such as large acquisitions.
- Conducting a thorough risk assessment and proposing options to mitigate risk. The boards of directors of the financial firms at the center of the global financial crisis were faulted for not noticing or not appreciating the risks the firms were exposed to.
- Ensuring that the firm's audited financial statements represent a true and accurate picture of the firm.
- Ensuring the firm's compliance with laws and regulations. The boards of directors of firms caught up in the large accounting scandals were faulted for being negligent in their company oversight and not adequately performing several of the functions listed here.

Board independence is critical to effectively fulfilling a board's governance responsibilities. Given that board members are directly responsible to shareholders, they have an incentive to ensure that the shareholders' interests are pursued. If not, they can experience a loss in reputation or can be removed outright. More and more directors are also exposed to legal repercussions should they fail in their fiduciary responsibility. To perform their strategic oversight tasks, board members apply the strategic management theories and concepts presented herein, among other more specialized tools such as those originating in finance and accounting.

To make the workings of a board of directors more concrete, Strategy Highlight 12.1 takes a close look at corporate governance at General Electric.

As discussed in Strategy Highlight 12.1, at GE the CEO normally serves not only as the chief executive officer of the roughly \$240 billion conglomerate in market cap, but also as chairman of the board. This practice of **CEO/chairperson duality**—holding both the role of CEO and chairperson of the board—has been declining somewhat in recent years.³⁰ Among the largest 500 publicly traded companies in the United States, almost 70 percent of firms had the dual CEO-chair arrangement in 2005 (before the global financial crisis), but this number had declined to 52 percent of companies in 2016 (post global financial crisis).

CEO/chairperson duality Situation where the CEO of a publicly traded company is also the chairperson of the board of directors.

The functions of the CEO and chairperson of the board roles are distinctly different. A board of directors broadly oversees a company's business activities. The company's CEO reports to the board of directors and acts as a liaison between the company and the board. The CEO has high-level responsibilities of strategy and all other management activities of a company while the functions of the board of directors include approving the annual budget and dealing with stakeholders. Moreover, a CEO is the public face of a company or organization and takes the hit or pat on the back if a company fails or succeeds, while the board of directors is there to steer a company on behalf of shareholders.

Arguments can be made both for and against splitting the roles of CEO and chairperson of the board. On the one hand, the CEO has invaluable inside information that can help in chairing the board effectively. The benefit of a combined CEO and chair of the board is the unity streamlines and speeds the decision-making process as well as strategy implementation. On the other hand, the chairperson may influence the board unduly through setting the meeting agendas or suggesting board appointees who are friendly toward the CEO. Because one of the key roles of the board is to monitor and evaluate the CEO's performance, there can be a conflict of interest when the CEO actually chairs the board.

Strategy Highlight 12.1

GE's Board of Directors

GE describes the role of its board of directors as follows:

"The primary role of GE's Board of Directors is to oversee how management serves the interests of shareowners and other stakeholders. To do this, GE's directors have adopted corporate governance principles aimed at ensuring that the Board is independent and fully informed on the key strategic and risk issues GE faces. . . . Each independent director is expected to visit at least two GE businesses without the involvement of corporate management."³¹

The GE board is composed of individuals from the business world (chairpersons and CEOs of Fortune 500 companies spanning a range of industries), academia (business school and science professors, deans, and provosts), and government (SEC). Including the board's chairperson, GE's board has 18 members. Experts in corporate governance consider that an appropriate number of directors for a company of GE's size (roughly \$120 billion in annual revenues, which makes GE the largest industrial enterprise globally).

As of 2017, 17 of the 18 board members (94 percent) are independent outside directors. To achieve board independence, experts in corporate governance recommend that two-thirds of its directors be outsiders. GE's board tries to maintain only one inside director. This was demonstrated when former CEO Jeffrey Immelt retired in 2017. John Flannery took over in August, with Immelt scheduled to remain chairman of the board through the end of the year, after which Flannery would take over. In roughly half

of U.S. public firms, the CEO of the company also serves as chair of the board of directors.³²

GE's board of directors meets a dozen or more times annually. With increasing board accountability in recent years, boards now tend to meet more often. Many firms limit the number and type of directorships a board member may hold concurrently. To accomplish their responsibilities, boards of directors are usually organized into committees. GE's board has four committees, each with its own chair: the audit committee, the management development and compensation committee, the government and public affairs committee, and the technology and industrial risk committee.

In general, women and minorities remain underrepresented on boards of directors across the United States and throughout most of the world. GE's board is somewhat more diverse in gender when compared with other Fortune 500 companies, which in 2016 averaged roughly 20 percent women on their boards versus 28 percent for GE.³³

Generally, the larger the company, the greater its gender diversity, as demonstrated in recent years by tracking different levels of the Fortune 1000. For example, in 2016 boards of the Fortune 100 companies averaged 22 percent gender diversity; of the Fortune 500 (as noted), 20 percent; and of the bottom half of the Fortune 1000, 16 percent. GE as of this writing ranks number eight in the Fortune 1000 rankings in terms of gender diversity.³⁴

Diversity in backgrounds and expertise in the boardroom is considered an asset: More diverse boards are less likely to fall victim to *groupthink*, a situation in which opinions coalesce around a leader without individuals critically challenging and evaluating that leader's opinions and assumptions.³⁵

LO 12-5

Evaluate other governance mechanisms.

OTHER GOVERNANCE MECHANISMS

While the board of directors is the central governance piece for a public stock company, several other corporate mechanisms are also used to align incentives between principals and agents, including

- Executive compensation.
- The market for corporate control.
- Financial statement auditors, government regulators, and industry analysts.

EXECUTIVE COMPENSATION. The board of directors determines executive compensation packages. To align incentives between shareholders and management, the board frequently

grants **stock options** as part of the compensation package. This mechanism is based on agency theory and gives the recipient the right, but not the obligation, to buy a company's stock at a predetermined price sometime in the future. If the company's share price rises above the negotiated strike price, which is often the price on the day when compensation is negotiated, the executive stands to reap significant gains.

The topic of executive compensation—and CEO pay, in particular—has attracted significant attention in recent years. Two issues are at the forefront:

1. The absolute size of the CEO pay package compared with the pay of the average employee.
2. The relationship between CEO pay and firm performance.

Absolute Size of Pay Package. The ratio of CEO to average employee pay in the United States is about 300 to 1, up from roughly 40 to 1 in 1980.³⁶ Based on a 2017 survey of CEOs in the S&P 500 by *The Wall Street Journal*, the median annual compensation was about \$11 million.³⁷ Note: Annual compensation is broadly defined to include salary, stock options, equity grants, bonuses, and pension payments.

The five highest paid CEOs were Thomas Rutledge of Charter Communications (\$98.5 million), Fabrizio Freda of Estée Lauder (\$48.4 million), Mark Parker of Nike (\$47.6 million), Alex Molinaroli of Johnson Controls (\$46.4 million), and Robert Iger of Disney (\$43.9 million). Noteworthy are also the two lowest paid CEOs in the S&P 500: Warren Buffett of Berkshire Hathaway (\$470,000) and Larry Page of Alphabet (\$1, the minimum payment required).³⁸

CEO Pay and Firm Performance. Overall, survey results also show that two-thirds of CEO pay is linked to firm performance.³⁹ The relationship between pay and performance is positive, but the link is weak at best. Although agency theory would predict a positive link between pay and performance as this aligns incentives, some recent experiments in *behavioral economics* caution that incentives that are too high-powered (e.g., outsized bonuses) may have a negative effect on job performance.⁴⁰ That is, when the incentive level is very high, an individual may get distracted from strategic activities because too much attention is devoted to the outsized bonus to be enjoyed in the near future. This can further increase job stress and negatively impact job performance.

THE MARKET FOR CORPORATE CONTROL. Whereas the board of directors and executive compensation are *internal* corporate-governance mechanisms, the *market for corporate control* is an important *external* corporate-governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market. To avoid such attempts, corporate managers strive to protect shareholder value by delivering strong share-price performance or putting in place poison pills (discussed later).

Here's how the market for corporate control works: If a company is poorly managed, its performance suffers and its stock price falls as more and more investors sell their shares. Once shares fall to a low enough level, the firm may become the target of a *hostile takeover* (as discussed in Chapter 9) when new bidders believe they can fix the internal problems that are causing the performance decline. Besides competitors, so-called *corporate raiders* (e.g., Carl Icahn and T. Boone Pickens) or *private equity firms* and *hedge funds* (e.g., The Blackstone Group and Pershing Square Capital Management) may buy enough shares to exert control over a company.

In a **leveraged buyout (LBO)**, a single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares

stock options An incentive mechanism to align the interests of shareholders and managers, by giving the recipient the right (but not the obligation) to buy a company's stock at a predetermined price sometime in the future.

leveraged buyout (LBO) A single investor or group of investors buys, with the help of borrowed money (leveraged against the company's assets), the outstanding shares of a publicly traded company in order to take it private.

of a publicly traded company in order to take it private. In short, an LBO changes the ownership structure of a company from public to private. The expectation is often that the private owners will restructure the company and eventually take it public again through an initial public offering (IPO).

Private companies enjoy certain benefits that public companies do not. Private companies are not required to disclose financial statements. They experience less scrutiny from analysts and can often focus more on long-term viability. These are also some of the reasons some unicorns delay going public in the first place.

In 2013, computer maker Dell Inc. became a takeover target of famed corporate raider Carl Icahn.⁴¹ He jumped into action after Dell's founder and its largest shareholder, Michael Dell, announced in January of that year that he intended a *leveraged buyout* with the help of Silverlake Partners, a private equity firm, to take the company private. In the Dell buyout battle, many observers, including Icahn who is the second-largest shareholder of Dell, saw the attempt by Michael Dell to take the company private as the "ultimate insider trade."

This view implied that Michael Dell, who is also CEO and chairman, had private information about the future value of the company and that his offer was too low. Dell Inc., which had \$57 billion in revenues in its fiscal year 2013, has been struggling in the ongoing transition from personal computers such as desktops and laptops to mobile devices and services. Between December 2004 and February 2009, Dell (which until just a few years earlier was the number-one computer maker) lost more than 80 percent of its market capitalization, dropping from some \$76 billion to a mere \$14 billion. In late 2013, Dell's shareholders approved the founder's \$25 billion offer to take the company private, thus avoiding a hostile takeover.

If a hostile takeover attempt is successful, however, the new owner frequently replaces the old management and board of directors to manage the company in a way that creates more value for shareholders. In some instances, the new owner will break up the company and sell its pieces. In either case, since a firm's existing executives face the threat of losing their jobs and their reputations if the firm sustains a competitive disadvantage, the market for corporate control is a credible governance mechanism.

To avoid being taken over against their consent, some firms put in place a **poison pill**. These are defensive provisions that kick in should a buyer reach a certain level of share ownership without top management approval. For example, a poison pill could allow existing shareholders to buy additional shares at a steep discount. Those additional shares would make any takeover attempt much more expensive and function as a deterrent. With the rise of actively involved institutional investors, poison pills have become rare because they retard an effective function of equity markets.

Although poison pills are becoming rarer, the market for corporate control is alive and well, as shown in the battle over control of Dell Inc. or the hostile takeover of Cadbury by Kraft (featured in Strategy Highlight 9.2). However, the market for corporate control is a last resort because it comes with significant transaction costs. To succeed in its hostile takeover bid, buyers generally pay a significant premium over the given share price. This often leads to overpaying for the acquisition and subsequent shareholder value destruction—the so-called *winner's curse*. The market for corporate control is useful, however, when internal corporate-governance mechanisms have not functioned effectively and the company is underperforming.

poison pill Defensive provisions to deter hostile takeovers by making the target firm less attractive.

AUDITORS, GOVERNMENT REGULATORS, AND INDUSTRY ANALYSTS. Auditors, government regulators, and industry analysts serve as additional external-governance mechanisms. All public companies listed on the U.S. stock exchanges must file a number of

financial statements with the *Securities and Exchange Commission (SEC)*, a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. To avoid the misrepresentation of financial results, all public financial statements must follow *generally accepted accounting principles (GAAP)*⁴² and be audited by certified public accountants.

As part of its disclosure policy, the SEC makes all financial reports filed by public companies available electronically via the EDGAR database.⁴³ This database contains more than 7 million financial statements, going back several years. Industry analysts scrutinize these reports in great detail, trying to identify any financial irregularities and assess firm performance. Given recent high-profile oversights in accounting scandals and fraud cases, the SEC has come under pressure to step up its monitoring and enforcement.

Industry analysts often base their buy, hold, or sell recommendations on financial statements filed with the SEC and business news published in *The Wall Street Journal*, *Bloomberg Businessweek*, *Fortune*, *Forbes*, and other business media such as CNBC. Researchers have questioned the independence of industry analysts and credit-rating agencies that evaluate companies (such as Fitch Ratings, Moody's, and Standard & Poor's),⁴⁴ because the investment banks and rating agencies frequently have lucrative business relationships with the companies they are supposed to evaluate, creating conflicts of interest. A study of over 8,000 analysts' ratings of corporate equity securities, for example, revealed that investment bankers rated their own clients more favorably.⁴⁵

In addition, an industry has sprung up around assessing the effectiveness of corporate governance in individual firms. Research outfits, such as GMI Ratings,⁴⁶ provide independent corporate governance ratings. The ratings from these external watchdog organizations inform a wide range of stakeholders, including investors, insurers, auditors, regulators, and others.

Corporate-governance mechanisms play an important part in aligning the interests of principals and agents. They enable closer monitoring and controlling, as well as provide incentives to align interests of principals and agents. Perhaps even more important are the “most internal of control mechanisms”: *business ethics*—a topic we discuss next.

12.3 Strategy and Business Ethics

Multiple, high-profile accounting scandals and the global financial crisis have placed business ethics center stage in the public eye. **Business ethics** are an agreed-upon code of conduct in business, based on societal norms. Business ethics lay the foundation and provide training for “behavior that is consistent with the principles, norms, and standards of business practice that have been agreed upon by society.”⁴⁷ These principles, norms, and standards of business practice differ to some degree in different cultures around the globe. But a large number of research studies have found that some notions—such as fairness, honesty, and reciprocity—are universal norms.⁴⁸ As such, many of these values have been codified into law.

Law and ethics, however, are not synonymous. This distinction is important and not always understood by the general public. Staying within the law is a *minimum acceptable standard*. A note of caution is therefore in order: A manager's actions can be completely legal, but ethically questionable. For example, consider the actions of mortgage-loan officers who—being incentivized by commissions—persuaded unsuspecting consumers to sign up for exotic mortgages, such as “option ARMs.” These mortgages offer borrowers the choice to pay less than the required interest, which is then added to the principal while the interest rate can adjust upward. Such actions may be legal, but they are unethical, especially if there are indications that the borrower might be unable to repay the mortgage once the interest rate moves up.⁴⁹

LO 12-6

Explain the relationship between strategy and business ethics.

business ethics An agreed-upon code of conduct in business, based on societal norms.

To go beyond the minimum acceptable standard codified in law, many organizations have explicit *codes of conduct*. These codes go above and beyond the law in detailing how the organization expects an employee to behave and to represent the company in business dealings. Codes of conduct allow an organization to overcome moral hazards and adverse selections as they attempt to resonate with employees' deeper values of justice, fairness, honesty, integrity, and reciprocity. Since business decisions are not made in a vacuum but are embedded within a societal context that expects ethical behavior, managers can improve their decision making by also considering:

- When facing an ethical dilemma, a manager can ask whether the intended course of action falls within the *acceptable norms of professional behavior* as outlined in the organization's code of conduct and defined by the profession at large.
- The manager should imagine whether he or she would feel *comfortable explaining and defending the decision in public*. How would the media report the business decision if it were to become public? How would the company's stakeholders feel about it?

Strategy Highlight 12.2 features Goldman Sachs, which came under scrutiny and faced tough questions pertaining to its business dealings in the wake of the financial crisis of 2007–2008.

In the aftermath of the Abacus debacle (discussed in Strategy Highlight 12.2), Goldman Sachs revised its code of conduct. A former Goldman Sachs employee, Greg Smith, published a book chronicling his career at the investment bank, from a lowly summer intern (in 2000) to head of Goldman Sachs' U.S. equity derivatives business in Europe, the Middle East, and Africa (in 2012).⁵⁰ Smith's thesis was that the entire ethical climate within Goldman Sachs changed over that period. For its first 130 years, Goldman Sachs was organized as a professional partnership, like most law firms. In this organizational form, a selected group of partners are joint owners and directors of the professional service firms. After years of superior performance, associates in the professional service firms may "make partner"—being promoted to joint owner. During the time when organized as a professional partnership, Goldman Sachs earned a reputation as the best investment bank in the world. It had the best people and put its clients' interests first. Smith describes how Goldman's culture—and with it, employee attitudes—changed after the firm went public (in 1999), from "we are here to serve our clients as honorable business partners, and we have our clients' best interests in mind," to "we [Goldman Sachs and our clients] are all grown-ups and just counter parties to any transaction."⁵¹ In the latter perspective, unsuspecting clients in the Abacus deal were seen just as "counter parties to a transaction," who should have known better.

BAD APPLES VS. BAD BARRELS

Some people believe that unethical behavior is limited to a few "bad apples" in organizations.⁵² The assumption is that the vast majority of the population—and by extension, organizations—are good, and that we need only safeguard against abuses by a few bad actors. According to agency theory, it's the "bad agents" who act opportunistically, and principals need to be on guard against bad actors.

However, research indicates that it is not just the few "bad apples" but entire organizations that can create a climate in which unethical, even illegal behavior is tolerated.⁵³ While there clearly are some people with unethical or even criminal inclinations, in general one's ethical decision-making capacity depends very much on the organizational context. Research shows that if people work in organizations that expect and value ethical behavior, they are more likely to act ethically.⁵⁴ The opposite is also true. Enron's *stated* key values included respect and integrity, and its mission statement proclaimed that all business dealings should be open and fair.⁵⁵ Yet, the ethos at Enron was all about creating

Strategy Highlight 12.2

Why the Mild Response to Goldman Sachs and Securities Fraud?

Long after the SEC sued Goldman Sachs and one of its employees, Fabrice Tourre, for securities fraud, social critics continue to question what is now seen as a mild response by both the SEC and the Justice Department. (The SEC oversees civil enforcement of U.S. securities law; the Justice Department pursues criminal cases, often based on SEC investigations. Both can target institutions and individuals.)

The SEC's case in April 2010 was narrow, looking at a specific, mortgage-related scheme hatched in 2006 during the height of a U.S. real estate bubble. Then many investors assumed house prices could only go up, after years of consistent real estate appreciation. Indeed, real estate prices in the United States had continued to surge, as speculation was added to organic demand. The frenzy was also fueled by cheap mortgages, many of them extended to home buyers who really couldn't afford them. John Paulson, founder of the hedge fund Paulson & Co., saw the looming collapse—and a way to profit. He approached Goldman Sachs with a trading idea betting that the bubble would soon burst.

HIDDEN POISON. Paulson asked Goldman Sachs to create an investment instrument, later named “Abacus,” designed specifically to maximize returns on his bet. Goldman Sachs agreed and assigned Tourre to put it together. Tourre bundled thousands of mortgages into bonds, which theoretically would provide stable and regular interest payments (but only as long as the borrowers made mortgage payments). Such a bundle is known as a *collateralized debt obligation (CDO)*. CDOs are considered safer investment choices than owning individual loans themselves; risks of losses through default are evened out across a broad number of loans; the bigger the bundle, theoretically, the more stable the investment. But with Abacus, Paulson was helping Goldman Sachs by identifying the riskiest of CDOs to include in the bundle.

Rating agencies, including Standard & Poor's, Fitch, and Moody's, frequently rated CDOs as triple A. This is the highest possible rating and indicates an “extremely strong capacity” for the borrower to meet its financial obligation. Only a few companies, such as Exxon, Johnson & Johnson, and Microsoft, hold a triple A rating. Rating agencies may have been lulled by the traditional stability of CDO offerings and the general euphoria around real estate. They rubber-stamped Abacus as a triple A investment, and many institutional

investors, such as pension funds, snapped it up. The investment seemed above reproach: Triple A Abacus was offered by Goldman Sachs, the number-one investment bank in the world.

FABULOUS FAB. Yet according to internal e-mails, Paulson and several Goldman Sachs employees, including Tourre, knew otherwise. For example, Tourre, who had earlier been dubbed “fabulous Fab,” by a colleague, saw the nickname rebound publicly to his discredit when it came out under oath. Specifically, one e-mail was from Tourre to his girlfriend at the time, in which he described himself wistfully in the third person, anticipating the burst of the real estate bubble:

*The entire building is at risk of collapse at any moment. Only potential survivor, the fabulous Fab (. . . even though there is nothing fabulous about me. . .) standing in the middle of all these complex, highly leveraged, exotic trades he created without necessarily understanding all the implications of these monstrosities.*⁵⁶

SHORTING ABACUS. Goldman Sachs profited by selling Abacus despite internal knowledge of its true intent. For example, Goldman Sachs knew how Paulson had poisoned Abacus to insure its failure. As for Paulson, he took a “short position” in Abacus—meaning he bet it would fail. Paulson & Co. sold shares it did not yet own, in anticipation that the value would fall and Paulson would cover its sold shares by buying them at the fallen price. In contrast, institutional investors, often long-term Goldman clients, believed Abacus was a great investment opportunity. When the real estate bubble burst, Paulson made more than \$1 billion from his position in Abacus.

SETTLEMENT AND CONVICTION. Did Goldman Sachs defraud investors? The SEC argued that it did so, by knowingly misleading investors and failing to disclose Paulson's role in Abacus. Specifically, the SEC alleged that Goldman violated its *fiduciary responsibility*. Mounting a legalistic defense, Goldman Sachs argued that clients must always assess the risks involved in any investment. Public pressure mounted, however, and Goldman Sachs settled the lawsuit with the SEC by paying a \$550 million fine without admitting any wrongdoing. Tourre declined a settlement, and his case went to court. In August 2013, Tourre was convicted of securities fraud.

As for Tourre, he decided not to appeal the decision, stating instead he wished to complete his doctoral studies and hoped to make contributions to scholarship in the field of economics.⁵⁷

(continued)

UPDATE. So where do things stand? Between 2011 and 2017, Tourre studied for a PhD degree in economics at the University of Chicago. In 2015, Paulson donated \$400 million to Harvard University to endow the School of Engineering and Applied Sciences, and have it renamed after him. No charges were ever filed against Paulson or top executives at Goldman Sachs.

Critics find it odd that the only individual charged was the management-level Tourre. An investigation by

journalist Jesse Eisinger was published in *The New Yorker* in 2016 detailing the SEC's timidity and was expanded into a book in 2017. Eisinger looks in detail at how prosecutors and investigators can find it easier to sympathize with high-ranking executives they see as real people than they do with the more faceless victims of fraud. The book's subtitle? "Why the Justice Department Fails to Prosecute Executives."⁵⁸

an inflated share price at any cost, and its employees observed and followed the behavior set by their leaders.

Sometimes, it's the bad barrel that can spoil the apples! This is precisely what Smith argues in regard to Goldman Sachs: The ethical climate had changed for the worse, so that seeing clients as mere "counter parties" to transactions made deals like Abacus possible. One could argue that Tourre simply followed the values held within Goldman Sachs ("profit is king" and "clients are grown-ups"). As a mid-level employee, many view Tourre as the scapegoat in the Abacus case.⁵⁹

Employees take cues from their environment on how to act. Therefore, ethical leadership is critical, and strategic leaders set the tone for the ethical climate within an organization. This is one of the reasons the HP board removed then-CEO Mark Hurd in 2010 even without proof of illegal behavior or violation of the company's sexual-harassment policy. The forced resignation was prompted by a lawsuit alleging sexual harassment against Hurd by a former adult movie actress who worked for HP as an independent contractor. This action goes to show that CEOs of Fortune 500 companies are under constant public scrutiny and ought to adhere to the highest ethical standards. If they do not, they cannot rationally expect their employees to behave ethically. Unethical behavior can quickly destroy the reputation of a CEO, one of the most important assets he or she possesses.

To foster ethical behavior in employees, boards must be clear in their ethical expectations, and top management must create an organizational structure, culture, and control system that values and encourages desired behavior. Furthermore, a company's formal and informal cultures must be aligned, and executive behavior must be in sync with the formally stated vision and values. Employees will quickly see through any duplicity. Actions by executives speak louder than words in vision statements.

Other leading professions have accepted codes of conduct (e.g., the bar association in the practice of law and the Hippocratic oath in medicine); management has not.⁶⁰ Some argue that management needs an accepted code of conduct,⁶¹ holding members to a high professional standard and imposing consequences for misconduct. Misconduct by an attorney, for example, can result in being disbarred and losing the right to practice law. Likewise, medical doctors can lose their professional accreditations if they engage in misconduct.

To anchor future managers in professional values and to move management closer to a truly professional status, a group of Harvard Business School students developed an MBA oath (see Exhibit 12.4).⁶² Since 2009, over 6,000 MBA students from more than 300 institutions around the world have taken this voluntary pledge. The oath explicitly recognizes the role of business in society and its responsibilities beyond shareholders. It also holds managers to a high ethical standard based on more or less universally accepted principles in order to "create value responsibly and ethically."⁶³ Having the highest personal integrity is of utmost importance to one's career. It takes decades to build a career, but sometimes just

EXHIBIT 12.4 /**The MBA Oath**

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As a business leader I recognize my role in society.

- *My purpose is to lead people and manage resources to create value that no single individual can create alone.*
- *My decisions affect the well-being of individuals inside and outside my enterprise, today and tomorrow.*

Therefore, I promise that:

- *I will manage my enterprise with loyalty and care, and will not advance my personal interests at the expense of my enterprise or society.*
- *I will understand and uphold, in letter and spirit, the laws and contracts governing my conduct and that of my enterprise.*
- *I will refrain from corruption, unfair competition, or business practices harmful to society.*
- *I will protect the human rights and dignity of all people affected by my enterprise, and I will oppose discrimination and exploitation.*
- *I will protect the right of future generations to advance their standard of living and enjoy a healthy planet.*
- *I will report the performance and risks of my enterprise accurately and honestly.*
- *I will invest in developing myself and others, helping the management profession continue to advance and create sustainable and inclusive prosperity.*

In exercising my professional duties according to these principles, I recognize that my behavior must set an example of integrity, eliciting trust and esteem from those I serve. I will remain accountable to my peers and to society for my actions and for upholding these standards.

This oath I make freely, and upon my honor.

a few moments to destroy one. The voluntary MBA oath sets professional standards, but its effect on behavior is unknown, and it does not impose any consequences for misconduct.

12.4 Implications for Strategic Leaders

An important implication for the strategic leader is the recognition that effective corporate governance and solid business ethics are critical to gaining and sustaining competitive advantage. Governance and ethics are closely intertwined in an intersection of setting the right organizational core values and then ensuring compliance.

A variety of corporate governance mechanisms can be effective in addressing the principal-agent problem. These mechanisms tend to focus on monitoring, controlling, and providing incentives, and they must be complemented by a strong code of conduct and strategic leaders who act with integrity. The effective strategic leader must help employees to “walk the talk”; leading by ethical example often has a stronger effect on employee behavior than words alone.

The strategist needs to look beyond shareholders and apply a stakeholder perspective to ensure long-term survival and success of the firm. A firm that does not respond to stakeholders beyond stockholders in a way that keeps them committed to its vision will not be successful. Stakeholders want fair treatment even if not all of their demands can be met. Fairness and transparency are critical to maintaining good relationships within the network of stakeholders the firm is embedded in. Finally, the large number of glaring ethical lapses over the last decade or so makes it clear that organizational core values and a code of conduct are key to the continued professionalization of management. Strategic leaders need to live organizational core values by example.

CHAPTERCASE 12 / Consider This. . .

WILL TRAVIS KALANICK'S departure as CEO allow Uber to develop a more grounded and ethical corporate culture? It may take several years to answer that question confidently. But in thinking about Uber's future, we can make some observations.

A Cynic's View. Critics may see the resignation of Kalanick as just one more stunt to reduce heat and scrutiny, and unlikely to result in meaningful change. Corporate culture is never easy to change, this line of reasoning goes, and Kalanick, as co-founder, remains a strong presence in two ways. First, even should he sever *all* ties with Uber, as co-founder he contributed much of the company's DNA (through the imprinting process discussed in Chapter 11), so the company is prone to lapses by nature. And second, Kalanick has *not* cut his ties; he still remains intimately involved in the company. Although no longer CEO and chairman, he keeps his board seat. In fact he remains one of three company insiders on the board, along with co-founder Garrett Camp and early employee Ryan Graves. This block holds a majority of the voting rights. Camp, Kalanick's long-time business partner, is now chairman of the board.

Beyond Cynicism. On the other hand, business as usual for Uber is becoming increasingly problematic. For years running, Uber seemed willing to flout rules, laws, and regulations because the service was liked by users who would not like the service to be removed. Uber's customers were happy because they could hail rides conveniently and cheaply, often in areas that were underserved by regular taxis; drivers were happy because they could choose when and how long to work; and local politicians were cautious about throwing a monkey wrench in the works. Why make your voters unhappy?

But that tactic works best at the local level, and Uber's challenges are increasingly broader, both nationally and internationally. Uber now fights well-funded lawsuits instead of hamstringing municipal bureaucrats. So Uber can no longer fly under the radar. Uber is so big and established that the CEO's boorish behavior or an employee's complaints about sexual harassment quickly go viral on a global basis.

Eye on the Prize. Uber may be at a point in its trajectory where investors simply won't allow it to continue a self-destructive tendency to cut ethical corners. Too much is at stake. In this line of thought, the biggest opportunity with Uber is not its current business. Uber's goal remains centered around self-driving cars, supported by high-powered mobile logistics networks, and online mapping systems. Therefore, in this view, its current business is secondary. Recall from the



Travis Kalanick, Uber's co-founder, was forced to resign as CEO in the summer of 2017 under mounting pressure by investors over his alleged role in and mishandling of Uber's litany of ethical challenges. Shortly after Kalanick's resignation, Uber's board presented Dara Khosrowshahi as the new Uber CEO. Khosrowshahi was CEO of Expedia (a travel website) at the time of his Uber appointment. ©Danish Siddiqui/REUTERS

start of the chapter and ChapterCase that even *The Wall Street Journal* opined in 2014 that Uber's biggest potential rival was itself—that only Uber was able to bring down Uber.⁶⁴

Which takes us back to Uber's naturally disruptive nature. With a fleet of autonomous vehicles offering cheap rides, people don't need to own cars anymore. When car ownership is no longer needed, it will certainly impact the old-line car manufacturers. From there Uber might expand into the "delivery of everything," taking over last-mile deliveries for Amazon.com and other online retailers. Uber might even work in concert with shippers such as UPS and FedEx.

One Possible Future. Note that in this version of the future, in which Uber is the primary player and provider for self-driving car technology, and controls the platform under which we might summon a car to our door, some of Uber's current challenges disappear. Kalanick was pitching benefits to the consumer when he stated: "The reason Uber could be expensive is because you're not just paying for the car—you're paying for the other dude in the car. When there's no other dude in the car, the cost of taking an Uber anywhere becomes cheaper than owning a vehicle."⁶⁵ Not having to deal with drivers must sound attractive to Uber, which has had antagonisms with its work force, as the viral video of the argument between a driver and Kalanick showed. Uber also still has to subsidize rates to the drivers. On the regulatory front it's reasonable to assume that states will continue to remove obstacles

to self-driving cars and the companies that manage them. So in this future, many of its compliance failures go away too.

Current Challenges. But Uber has to get through current challenges to reach its future goals. Before Kalanick resigned, the most visible efforts to deal with scandals and controversies were to manage perception. In 2015 Uber hired David Plouffe as senior vice president of policy and strategy, explicitly to improve public relations and to lobby politicians. Previously, Plouffe had been the manager for the 2008 Obama presidential campaign and then a senior adviser in the administration. At Uber he pitched the social benefit of Uber's contribution to the transportation ecosystem and its ability to fix traffic congestion, cut down on drunk driving, and provide reliable and safe services to underserved city and suburban areas—even helping to end poverty by providing greater access to reliable transportation. And he minimized criticisms as misguided.⁶⁶

Exodus of Talent. Plouffe walked away in early 2017. He was followed by Rachel Whetstone, who headed policy and communications globally; she was hired in 2015 and left in April 2017. In fact, a steady trail of senior executives and lead engineers has left Uber in the wake of the continuous scandals that plague the brash startup. They include Uber's head of autonomous car technology, head of online mapping, and an artificial-intelligence (AI) expert. Some cited issues with the company's values as the reason for their departure. When resigning after only six months on the job in spring 2017, Uber President Jeff Jones stated, "The beliefs and approach to leadership that have guided my career are inconsistent with what I saw and experienced at Uber."⁶⁷

Keep in mind that Uber has not yet gone public, so most executives and engineers likely left millions of dollars on the table when they left. That is, they left behind promised stock options due to their premature departure. Going public is key to understanding Uber in the long run. Uber's board may have its own timetable for that step, but an IPO will

allow Uber's investors to realize their gains in a big way. If an IPO is part of the board's plans, the company must develop a more mature, professional, and diverse cadre of managers. Otherwise, Uber's trail of unresolved ethical issues and lawsuits could derail an envisioned IPO, or at least of realizing full value in the market.

Hope for the Future. If Uber is able to mend its ways—and much depends on how the full board responds to major investors—Uber has a much better chance of realizing the future it hopes will unfold.⁶⁸

Questions

1. Have you used a ride-hailing service such as Uber or Lyft? How was your experience?
2. Would like to work for Uber? Why or why not?
3. Explain Uber's business model and deduce its strategic intent.
4. Do you agree with Peter Thiel's assessment that Uber is the "most ethically challenged company in Silicon Valley"? Why or why not? Explain.
5. Some observers had argued that Uber's greatest problem was not any of its scandals, but its CEO Travis Kalanick. Now that Kalanick no longer serves that role, how much better off is Uber really? Where do you come down? Do you think Kalanick's reduced profile will turn the tide for Uber? Or is Kalanick's drive and competitiveness necessary to Uber's continued success, regardless of the title he holds? If you were on the board, what would you recommend? And why?
6. Uber's new CEO, Dara Khosrowshahi, declared that he envisions Uber going public in early 2019, that is, within 18 months of his appointment. What would he and Uber need to accomplish to make this a reality? List Uber's current challenges in rank order, and provide recommendations to the new CEO of how to address them. Be specific.

TAKE-AWAY CONCEPTS

In this final chapter, we looked at stakeholder strategy, corporate governance, business ethics, and strategic leadership, as summarized by the following learning objectives and related take-away concepts.

LO 12-1 / Describe the shared value creation framework and its relationship to competitive advantage.

- By focusing on financial performance, many companies have defined value creation too narrowly.
- Companies should instead focus on creating *shared value*, a concept that includes value creation for both shareholders and society.
- The shared value creation framework seeks to identify connections between economic and social needs, and then leverage them into competitive advantage.

LO 12-2 / Explain the role of corporate governance.

- Corporate governance involves mechanisms used to direct and control an enterprise to ensure that it pursues its strategic goals successfully and legally.
- Corporate governance attempts to address the principal–agent problem, which describes any situation in which an agent performs activities on behalf of a principal.

LO 12-3 / Apply agency theory to explain why and how companies use governance mechanisms to align interests of principals and agents.

- Agency theory views the firm as a nexus of legal contracts.
- The principal–agent problem concerns the relationship between owners (shareholders) and managers and also cascades down the organizational hierarchy.
- The risk of opportunism on behalf of agents is exacerbated by information asymmetry: Agents are generally better informed than the principals.
- Governance mechanisms are used to align incentives between principals and agents.
- Governance mechanisms need to be designed in such a fashion as to overcome two specific agency problems: adverse selection and moral hazard.

LO 12-4 / Evaluate the board of directors as the central governance mechanism for public stock companies.

- The shareholders are the legal owners of a publicly traded company and appoint a board of directors to represent their interests.
- The day-to-day business operations of a publicly traded stock company are conducted by its managers and employees, under the direction of the chief executive officer (CEO) and the oversight of the board of directors. The board of directors is composed of inside and outside directors, who are elected by the shareholders.
- Inside directors are generally part of the company's senior management team, such as the chief financial officer (CFO) and the chief operating officer (COO).
- Outside directors are not employees of the firm. They frequently are senior executives from other

firms or full-time professionals who are appointed to a board and who serve on several boards simultaneously.

LO 12-5 / Evaluate other governance mechanisms.

- Other important corporate mechanisms are executive compensation, the market for corporate control, and financial statement auditors, government regulators, and industry analysts.
- Executive compensation has attracted significant attention in recent years. Two issues are at the forefront: (1) the absolute size of the CEO pay package compared with the pay of the average employee and (2) the relationship between firm performance and CEO pay.
- The board of directors and executive compensation are internal corporate-governance mechanisms. The market for corporate control is an important external corporate-governance mechanism. It consists of activist investors who seek to gain control of an underperforming corporation by buying shares of its stock in the open market.
- All public companies listed on the U.S. stock exchanges must file a number of financial statements with the Securities and Exchange Commission (SEC), a federal regulatory agency whose task it is to oversee stock trading and enforce federal securities laws. Auditors and industry analysts study these public financial statements carefully for clues of a firm's future valuations, financial irregularities, and strategy.

LO 12-6 / Explain the relationship between strategy and business ethics.

- The ethical pursuit of competitive advantage lays the foundation for long-term superior performance.
- Law and ethics are not synonymous; obeying the law is the minimum that society expects of a corporation and its managers.
- A manager's actions can be completely legal, but ethically questionable.
- Some argue that management needs an accepted code of conduct that holds members to a high professional standard and imposes consequences for misconduct.

KEY TERMS

Adverse selection (<i>p.</i> 427)	Corporate governance (<i>p.</i> 425)	Poison pill (<i>p.</i> 432)
Agency theory (<i>p.</i> 426)	Inside directors (<i>p.</i> 428)	Shared value creation framework (<i>p.</i> 424)
Board of directors (<i>p.</i> 428)	Leveraged buyout (LBO) (<i>p.</i> 431)	Shareholder capitalism (<i>p.</i> 422)
Business ethics (<i>p.</i> 433)	Moral hazard (<i>p.</i> 427)	Stock options (<i>p.</i> 431)
CEO/chairperson duality (<i>p.</i> 429)	Outside directors (<i>p.</i> 428)	

DISCUSSION QUESTIONS

1. How can a top management team lower the chances that key managers will pursue their own self-interests at the expense of stockholders? At the expense of the employees? At the expense of other key stakeholders?
2. The Business Roundtable has recommended that the CEO should not also serve as the chairman of the board. Discuss the disadvantages for building a sustainable competitive advantage if the two positions are held by one person. What are the disadvantages for stakeholder management? Are there situations where it would be advantageous to have one person in both positions?

ETHICAL/SOCIAL ISSUES

1. The shared value creation framework provides help in making connections between economic needs and social needs in a way that transforms into a business opportunity. Taking the role of consultant to Nike Inc., discuss how Nike might move beyond selling high-quality footwear and apparel and utilize its expertise to serve a social need. Give Nike some advice on actions the company could take in different geographic markets that would connect economic and social needs.
2. Assume you work in the accounting department of a large software company. Toward the end of December, your supervisor tells you to change the dates on several executive stock option grants from March 15 to July 30. Why would she ask for this change? What should you do?
3. As noted in the chapter, the average compensation for a CEO of an S&P 500 company in 2017 was \$11 million, and CEO pay was 300 times the average worker pay. This contrasts with historic values of between 25 and 40 times the average pay. In 2015 the U.S. Securities and Exchange Commission (SEC) approved a rule mandating that U.S. firms publicly disclose the gap between their CEO annual compensation and the median pay of the firm's other employees.
 - a. What are the potentially negative effects of this large and increasing disparity in CEO pay?
 - b. Do you believe that current executive pay packages are justified? Why or why not?

SMALL GROUP EXERCISES

//// Small Group Exercise 1

Uber is a highly valued “unicorn,” with a high disregard for regulations and other external factors that would slow its growth as discussed in this chapter. Other competing firms are taking a somewhat different route to the ride-hailing marketplace. For example, Lyft (discussed in ChapterCase 9) was also started in San Francisco, and since 2012 it has been growing across the country and more slowly internationally. Lyft started as a ride-sharing service targeting U.S. college students heading home for the holidays. The firm continues to focus on building a trusting community of drivers and riders—a community that is both social and cost-effective. In 2017 Lyft added to a prior partnership with General Motors by allying with Waymo (an Alphabet company). Another Uber competitor is Didi Chuxing, a dominant ride-hailing service in China.

In your groups, do internet research about Uber competitors (www.lyft.com and <http://www.xiaojukeji.com/en/index.html> will get you started).

1. What similarities and differences do you find in the way these firms have implemented sometimes similar ideas?
2. Discuss why traditional taxi companies, such as Yellow Cabs and those needing medallions (such as in New York City), are choosing to attempt to prohibit these app-enabled, ride-hailing services rather than aggressively implementing their own app-calling systems.

//// Small Group Exercise 2

The MBA oath (shown in Exhibit 12.4) says in part, “My decisions affect the well-being of individuals inside and outside my enterprise, today and tomorrow.”

One example of a large firm reorienting toward this approach is PepsiCo. In the last few years, PepsiCo has been contracting directly with small farmers in impoverished areas (for example, in Mexico). What started as a pilot project in PepsiCo’s Sabritas snack food division has now spread to farmers in more than 15 countries providing potatoes, corn, sunflower oil, and other products to the firm. PepsiCo provides a price guarantee to farmers that is higher and much more consistent than the previous system of using intermediaries. The farmers report that since they have a firm market, they are planting more crops. Output is up about 160 percent, and farm incomes have tripled in recent years. The program has benefits for PepsiCo as well. A shift to sunflower oil for its Mexican products will replace the 80,000 tons of palm oil it imports to Mexico from Asia and Africa, thus slashing transportation and storage costs. The firm is expanding the farmer sustainability program with plans to cover about 7 million acres, or 75 percent of its agricultural spending by 2025.

1. What are the benefits of this program for PepsiCo? What are its drawbacks?
2. What other societal benefits could such a program have in Mexico?
3. If you were a PepsiCo shareholder, would you support this program? Why or why not?

mySTRATEGY

Are You Part of Gen Y, or Will You Manage Gen-Y Workers?

Generation Y (born between 1980 and 2001) is entering the work force and advancing their careers now, as the baby boomers begin to retire in large numbers. Given the smaller size of Gen Y compared to the baby boomers, this generation received much more individual attention from their immediate and extended families. Classes in

school were much smaller than in previous generations. The parents of Gen Y placed a premium on achievement, both academically and socially. Gen Y grew up during a time of unprecedented economic growth and prosperity, combined with an explosion in technology (including laptop computers, cell phones, the internet, e-mail, instant messaging, and online social networks).

Gen Yers are connected 24/7 and are able to work anywhere, frequently multitasking. Due to the circumstances of their upbringing, they are said to be tech-savvy, family- and

friends-centric, team players, achievement-oriented, but also attention-craving.⁶⁹

Some have called Generation Y the “trophy kids,” due in part to the practice of giving all Gen-Y children trophies in competitive activities, not wanting to single out winners and losers. When coaching a group of Gen-Y students for job interviews, a consultant asked them how they believe future employers view them. She gave them a clue to the answer: the letter E. Quickly, the students answered confidently: *excellent*, *enthusiastic*, and *energetic*. The answer the consultant was looking for was “entitled.” Baby boomers believe that Gen Y has an overblown sense of entitlement.

When Gen Yers bring so many positive characteristics to the workplace, why do baby boomers view Gen-Y employees as entitled? Many managers are concerned that these young workers have outlandish expectations when compared with other employees: They often expect higher pay, flexible work schedules, promotions and significant raises every year, and generous vacation and personal time.⁷⁰ Managers also often find that for Gen-Y employees, the traditional annual or semiannual performance evaluations are not considered sufficient. Instead, Gen-Y employees seek more immediate feedback, ideally daily or at least weekly. For many, feedback needs to come in the form of positive reinforcement rather than as a critique.

The generational tension seems a bit ironic, since the dissatisfied baby boomer managers are the same indulgent parents who raised Gen Yers. Some companies, such as Google, Intel, and Sun Microsystems (Sun), have leveraged this tension into an opportunity. Google, for example, allows its engineers to spend one day a week on any project of their own choosing, thus meeting the Gen-Y need for creativity and self-determination. Executives at Intel have learned to motivate Gen-Y employees by sincerely respecting their contributions as colleagues rather than relying on hierarchical or position power. The network-computing company Sun accommodates Gen Yers’ need for flexibility through drastically increasing work-from-home and telecommunicating arrangements; all employees now have a “floating office.” Netflix has eliminated all tracking of vacation time for employees, essentially allowing unlimited days off—as long as the work still gets done.

1. As this cohort expands in the work force, do you expect to see a different set of business ethics take hold?
2. Are efforts such as the MBA oath (discussed in this chapter) reflections of a different approach that Gen Y will bring to the business environment, compared with prior generations?

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PART 4 MiniCases*

*Assignable case analyses for each of these MiniCases are available on Connect.

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How to Conduct a Case Analysis

MiniCase 1

Michael Phelps: The Role of Strategy in Olympics and Business

MICHAEL PHELPS, nicknamed MP, is the most decorated Olympian of all time. Competing in five Olympic Games,¹ the American swimmer won 28 Olympic medals, including 23 gold! In 2000 at the Sydney Olympics, Phelps at the age of 15 was the youngest U.S. athlete in almost seven decades. In 2008 at the Beijing Olympics, he won an unprecedented eight gold medals, and while doing so set seven world records. Eight short days changed Olympic history and Phelps' life forever, making him one of the greatest athletes of all time. Immediately after the event, *The Wall Street Journal* reported that Phelps would be likely to turn the eight gold medals into a cash-flow stream of more than \$100 million through several product and service endorsements.

He did not rest on his laurels, however. In subsequent Summer Olympics, Phelps added another four gold and two silver medals in London (2012), and five gold medals and one silver in Rio de Janeiro (2016). He became an Olympic superhero against long odds. Who would have predicted this level of success?

In his youth, Phelps was diagnosed with attention deficit hyperactivity disorder (ADHD). Doctors prescribed swimming to help him release his energy. It worked! He excelled at swimming, and the focus may have helped him succeed in academics too. Between 2004 and 2008, he attended the University of Michigan, studying marketing and management.

Strategy Formulation

Strategy entered his life at a crucial point. He had already competed successfully in the 2004 Athens Summer Olympics, where he won eight medals: six gold and two bronze. Right after the Athens Games, the then 19-year-old sat down with his manager, Peter Carlisle, and his long-time swim coach, Bob Bowman, to map out a detailed strategy for the next four years. The explicit goal was to win nothing less than a gold medal in each of the events in which he would compete in Beijing.

Bowman was responsible for training Phelps, getting him into the necessary physical shape for Beijing and



Michael Phelps, the most decorated Olympian, turned into an entrepreneur.
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nurturing the mental toughness required to break Mark Spitz's 36-year-old record of seven gold medals won in the 1972 Munich Olympic Games. Carlisle, meanwhile, conceived of a detailed strategy to launch MP as a world superstar during the Beijing Games. While Phelps spent six hours a day in the pool, Carlisle focused on exposing him to the Asian market, the largest consumer market in the world, with a special emphasis on the Chinese consumer. Phelps' wide-ranging presence in the real world was combined with a huge exposure in the virtual world. Phelps posts and maintains his own Facebook page, with some 9 million "phans." He is also a favorite on Twitter (2.2 million followers), YouTube, and online blogs, garnering worldwide exposure to an extent never before achieved by an Olympian. The gradual buildup of Phelps over a number of years enabled manager Carlisle to launch him as a superstar right after he won his eighth gold medal at the Beijing Games. By then, Phelps had become a worldwide brand.

You might attribute Phelps' success to his unique physical endowments: his long thin torso, which reduces drag; his arm span of 6 feet 7 inches (204 cm), which is disproportionate to his 6-foot-4-inch (193 cm) height;

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his relatively short legs for a person of his height; and his size 14 feet, which work like flippers due to hypermobile ankles. After all, a successful strategy can be based on leveraging unique resources and capabilities.

While MP's physical attributes are a necessary condition for winning, they are not sufficient. Other swimmers, like the Australian Ian Thorpe (with size-17 feet) or the German "albatross" Michael Gross (with an arm span of 7 feet or 213 cm), also brought extraordinary resource endowments to the swim meet. Yet neither of them (or any other person for that matter) won eight gold medals in a single Olympics or 28 medals overall.

Strategy Implementation

Although Phelps was very disciplined in executing his meticulously formulated strategy to win Olympic gold medals, he stumbled in his efforts to monetize his stardom outside the pool. Image matters. In 2004, Phelps was arrested for driving under the influence (DUI). Following the 2008 Beijing Olympics, a British tabloid published a photo that showed Phelps using a bong, apparently smoking marijuana, at a party in South Carolina. After this incident, Kellogg's immediately withdrew Phelps' endorsement contract. After the London 2012 Olympics, Phelps (then 25) announced his retirement from swimming. After 20 months, he announced he would come out of retirement. However, just a few months later, in September 2014, Phelps was again arrested for DUI. After this second arrest, he received a one-year suspended jail sentence and 18 months of supervised probation. Phelps also spent 45 days in an in-patient rehab center for alcohol abuse in Arizona. USA Swimming, the national governance body of his sport, suspended him for six months from all competitions and from representing the United States at the 2015 world championships.

Yet Phelps persevered. He promised he had changed his ways. In the spring of 2015, he announced his intention to compete at the 2016 Rio Olympics. Subsequently, he won five gold medals and one silver there, making him the most decorated athlete in Olympic history! There are persistent rumors that Phelps may even compete at the 2020 Summer Olympics in Tokyo.

Of course, sponsors want to know whether the promised personal change is real, given that Phelps has made such promises after his first DUI and then again when photographed smoking a bong. Phelps assures the public that he has been intrinsically motivated to personally change after the London Olympics. He credits becoming a father (to a boy named Boomer) and spending time with his fiancée, Nicole Johnson, as the reasons

for becoming at peace with himself and who he is as a person (rather than living large as a celebrity).

Endorsements and Entrepreneurship

Phelps has shown he has even more reason to keep his public image clean. He launched his own line of swimwear, MP, trademarking his nickname as an official brand. The line was designed with Aqua Sphere, a swimming equipment manufacturer. Having grown up idolizing NBA star Michael Jordan, Phelps hopes he can do for the public image and marketing of swimming what Jordan, with his Nike sponsorship, did for in basketball. So while his swim line purrs along, Phelps continues to sign lucrative endorsement and advertisement deals, including a series of commercials for chip-maker Intel following the Rio Olympics.

DISCUSSION QUESTIONS

1. Olympians generally do not turn into global phenomena. One reason is that they are highlighted only every four years; e.g., not too many people follow competitive swimming or downhill skiing outside the Olympics. How did Michael Phelps turn into a global brand?
2. What role did strategy play in Phelps achieving success in and out of the pool? What general lessons can be learned?
3. Which approach to the strategy process did Phelps, his coach, and manager use? Why was this approach successful?
4. Phelps was embroiled in a number of controversies outside the pool. What impact did these shortcomings have on his brand value? What do these incidents tell you about maintaining and increasing brand value over time?
5. What does Phelps need to do if he wants to play a similar transformative role in the marketing and sponsoring of swimming as Michael Jordan achieved in basketball?

Endnote

1. Sydney in 2000; Athens in 2004; Beijing in 2008; London in 2012; and Rio de Janeiro in 2016.

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MiniCase 2

PepsiCo's Indra Nooyi: Performance with Purpose

"Performance with Purpose is not how we spend the money we make, it's how we make the money," says PepsiCo CEO Indra Nooyi.¹

AS CHIEF EXECUTIVE officer of PepsiCo, Indra Nooyi is one of the world's most powerful business leaders. A native of Chennai, India, Nooyi holds multiple degrees: a bachelor's degree in physics, chemistry, and mathematics from Madras Christian College; an MBA from the Indian Institute of Management; and a master's degree in public and private management from Yale University. Before joining PepsiCo in 1994, Nooyi worked for Johnson & Johnson, Boston Consulting Group, Motorola, and ABB. Indra Nooyi has been a regular in *Forbes'* Top 20 most powerful women for the past several years. However, she is not your typical Fortune 500 CEO: She is known for walking around the office barefoot and singing—a remnant from her days in an all-girls rock band in high school.

It should come as no surprise, therefore, that Nooyi has been shaking things up at PepsiCo, a company with roughly \$63 billion in annual revenues, \$165 billion in stock market valuation, some 264,000 employees worldwide, and business interests in more than 100 countries. She took the lead role in spinning off Taco Bell, Pizza Hut, and KFC in 1997. Later, she masterminded the acquisitions of Tropicana in 1998 and Quaker Oats, including Gatorade, in 2001. When becoming CEO in 2006, Nooyi declared PepsiCo's vision to be *Performance with Purpose*:

Performance with Purpose means delivering sustainable growth by investing in a healthier future for people and our planet.... We will continue to build a portfolio of enjoyable and healthier foods and beverages, find innovative ways to reduce the use of energy, water and packaging, and provide a great workplace for our associates.... Because a healthier future for all people and our planet means a more successful future for PepsiCo. This is our promise.²

In particular, *Performance with Purpose* has three dimensions:



Indra Nooyi, chief executive officer of PepsiCo, captures her strategic leadership with the mantra "Performance with Purpose."
©Jin Lee/Bloomberg/Getty Images

1. *Human sustainability.* PepsiCo's strategic intent is to make its product portfolio healthier to combat obesity by reducing sugar, sodium, and saturated fat content in certain key brands. It wants to reduce the salt and fat in its "fun foods" such as Frito-Lay and Doritos brands, and to include healthy choices such as Quaker Oats products and Tropicana fruit juices in its lineup. Nooyi is convinced that if food and beverage companies do not make their products healthier, they will face stricter regulation and lawsuits, as tobacco companies did. Nooyi's goal is to increase PepsiCo's revenues from nutritious foods, substantially as detailed in her 2025 *Performance with Purpose* agenda.³
2. *Environmental sustainability.* PepsiCo has instituted various initiatives to ensure that its operations don't harm the natural environment. The

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company has programs in place to reduce water and energy use, increase recycling, and promote sustainable agriculture. The goal is to transform PepsiCo into a company with a net-zero impact on the environment. Nooyi believes that young people today will not patronize or want to work for a company that does not have a strategy that also addresses ecological sustainability.

3. *The whole person at work.* PepsiCo wants to create a corporate culture in which employees do not “just make a living, but also have a life.” Nooyi argues that this type of culture allows employees to unleash both their mental and emotional energies.

PepsiCo's vision of *Performance with Purpose* acknowledges more than the importance of the corporate social responsibility and stakeholder strategy. Nooyi is convinced that companies have a duty to society to “do better by doing better.” She subscribes to a triple-bottom-line approach to competitive advantage, which considers not only economic but also social and environmental performance. Nooyi declares that the true profits of an enterprise are not just “revenues *minus* costs” but “revenues *minus* costs *minus* costs to society.” Problems such as pollution or the increased cost of health care to combat obesity impose costs on society that companies typically do not bear (externalities). As Nooyi sees it, the time when corporations can just pass on their externalities to society is nearing an end.

The external environment in the soft drink industry, however, has become much more challenging. Since their peak in the late 1990s, sales of carbonated soft drinks dropped some 25 percent. Consumption of bottled water, in contrast, surpassed the consumption of carbonated soft drinks in 2016. Energy drinks such as Monster or Red Bull are continuing to grow by double digits in the United States and overseas, making such products one of the hottest categories in the soft drink industry. Moreover, a wide range of governments, from municipalities such as Berkeley or Philadelphia in the United States to entire nation states such as France and Norway, now levy sugar taxes on soda drinks, making them much more expensive for consumers.

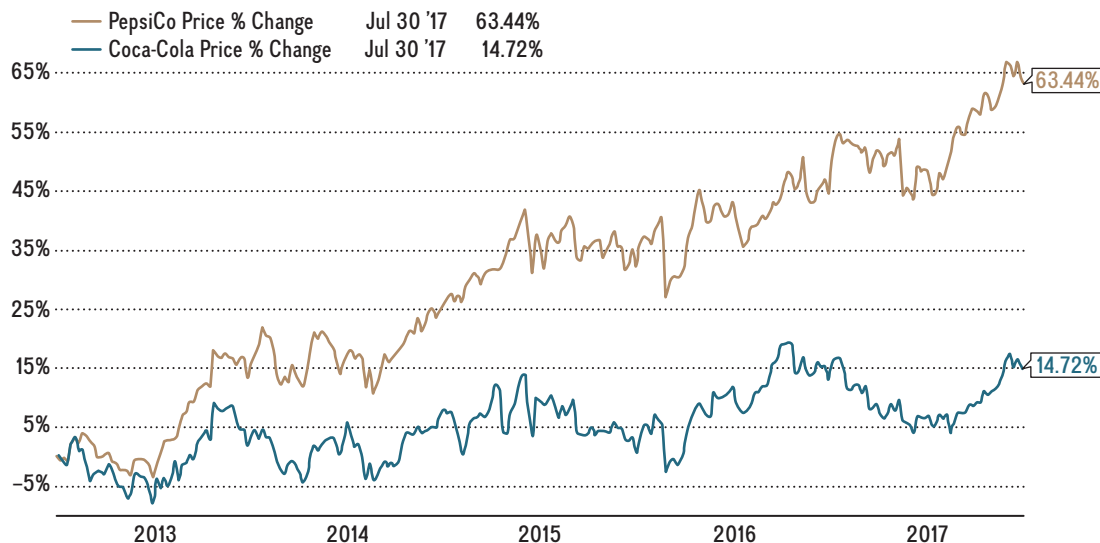
PepsiCo's archival Coca-Cola Co. continues to concentrate on its core business in soda and other non-alcoholic beverages. The full-calorie Coke remains America's most popular soda, as more and more people abandon artificially sweetened sodas (number two is PepsiCo's full-calorie cola and number three is Diet Coke). To enhance PepsiCo's strategic focus, critics of Nooyi propose splitting PepsiCo into two standalone

companies. One would focus on beverages (Pepsi, Gatorade, Tropicana); the other would focus on snack foods, several of which such as Lay's and Doritos have become multibillion-dollar brands. This move would unlock additional profit potential, the argument goes, because the well-performing snack food business would no longer need to subsidize underperforming beverages. For the time being, Nooyi has decided that PepsiCo creates more value when the beverage and snack foods divisions are together in one corporation, rather than split into two companies.

Although PepsiCo's revenues have remained more or less flat over the past few years, investors see significant growth potential. Over a five-year period between 2012 and 2017, PepsiCo has outperformed Coca-Cola by a relatively wide margin. During this period, PepsiCo's normalized stock appreciation was almost 50 percentage points higher than that of Coca-Cola (see Exhibit MC2.1). Albeit down from 90 percent in 2000, soda drinks still accounted for 70 percent of Coca-Cola's total revenues, while PepsiCo has been much more diversified. With better than expected financial results, Nooyi stands vindicated after years of criticism. Despite opposition, she stuck by her strategic mantra for PepsiCo—*Performance with Purpose*—and appears to be reaping the rewards.

DISCUSSION QUESTIONS

1. What grade would you give PepsiCo CEO Indra Nooyi for her job performance as a strategic leader? What are her strengths and weaknesses? Where would you place Nooyi on the Level-5 pyramid of strategic leadership (see Exhibit 2.2), and why? Support your answers.
2. The first few years after Indra Nooyi took over as PepsiCo's CEO and implemented *Performance with Purpose*, the company underperformed archival Coca-Cola Co. by a wide margin. What should a strategic leader do if his or her vision does not seem to lead to an immediate (financial) competitive advantage? What would be your top three recommendations? Support your arguments.
3. Do you agree with Indra Nooyi's philosophy that “performance and purpose are intimately linked and you can't do one without the other”? Support your arguments. Apply the *people, planet and profits* model of *sustainable strategy* (see Exhibit 5.9).
4. PepsiCo's investors require the company to grow about 5 percent or \$3.5 billion a year. PepsiCo's

EXHIBIT MC2.1 / Normalized Stock Performance of PepsiCo and Coca-Cola Co., June 2012 to June 2017

SOURCE: Depiction of publicly available data.

top line, however, remained flat for the past few years. Where would future growth for PepsiCo come from?

5. Some activist investors are putting pressure on Indra Nooyi to split PepsiCo into two standalone companies, with one focusing on beverages (Pepsi, Gatorade, Tropicana); the other would focus on snack foods (such as the Frito-Lay brand). What is the idea behind this corporate strategy? Do you think this move would add value for shareholders? For consumers? Other stakeholders? Why or why not?

Endnotes

1. As quoted in Safian, K. (2014, Oct. 14), "It's got to be a passion, it's gotta be your calling: Indra Nooyi," *Fast Company*.
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3. "Performance with Purpose: 2025 Agenda," https://www.pepsico.com/docs/album/sustainability-reporting/pepsico_sustainability_report_2015_and_-2025_agenda.pdf, accessed July 1, 2017.

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MiniCase 3

Yahoo: From Internet Darling to Fire Sale

WHEN SHE WAS APPOINTED CEO OF YAHOO IN 2012, Marissa Mayer had just one job: Turn the company around. Yahoo was once the go-to internet leader, a web portal with e-mail and finance, sports, social media, and video sharing services. Advertisers loved it. At the height of the dot-com bubble in the spring of 2000, Yahoo was valued at more than \$125 billion! In 2017, Yahoo's core internet business was sold to Verizon for a mere \$4.5 billion. What had happened?

By the time Marissa Mayer got the CEO job, Yahoo's market cap stood at \$19 billion. The once leading internet company had lost some 85 percent of its market value. Yahoo was in deep trouble as indicated by a high CEO turnover: Mayer was the seventh CEO in less than five years. By the time she sold Yahoo to Verizon five years later, Yahoo's market cap stood at \$53 billion. How did she almost triple the firm's market cap? And what explains the difference between the over \$50 billion market cap in 2017 and the sale price of less than \$5 billion to Verizon? Let's answer these questions one at a time. We begin by looking at Marissa Mayer's background and how she attempted to turn Yahoo around.

Pre-Yahoo

Mayer grew up in Wausau, Wisconsin, but took her higher education and built her career in California's Silicon Valley. She entered Stanford University in 1993, majoring in symbolic systems, a discipline that combines cognitive sciences, artificial intelligence, and human-computer interaction. Still at Stanford, Mayer earned a master's degree in computer science. On graduation in 1999, she declined over a dozen job offers, ranging from prestigious consulting firms to top-tier universities. Instead she went to a garage that housed a handful of employees for a small startup just a few months old. It was called Google.

Google's 20th hire and its first female engineer, Mayer became a star. With a superior skill set and strong work ethic, she rose quickly to the rank of vice



Marissa Mayer, CEO Yahoo, 2012–2017.

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president. She helped develop many of Google's best known features: Gmail, images, news, and maps. In particular, she designed the functionality and uncluttered look and feel of Google's iconic search site. Mayer is known for her attention to detail, her commitment of time, and her desire to provide the very best user experience possible, putting products before profits. She maintains that if you build the best products possible, profits will come. No doubt Mayer's pedigree at Google appealed to the Yahoo board. She was deeply involved in everything that Google had done right. And she was ready.

At Yahoo

Mayer's first acts at Yahoo revolved around mission, culture, and cash. She developed a new mission for

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Yahoo—to make the world's daily habits more inspiring and entertaining—to help reinvigorate Yahoo's employees and get its customers excited again. Mayer's mission attempted to inspire Yahoo's employees to resume leadership in online advertising. To retain existing talent and restore morale, she also had to sell her workers on the new mission. She did so by sharing this mantra with them via tweets and other means: *People then products then traffic then revenue*. Employees understood they were the start of the transformation. To put Yahoo's new mission into action, she also worked to rejuvenate Yahoo's bureaucratic culture and engaged in more open and frequent communication, with weekly FYI town-hall meetings where she and other executives provided updates and fielded questions. All employees were expected to attend and encouraged to participate in the Q&A. Questions were submitted online during the week, and the employees voted for which questions executives should address.

Mayer also took on Yahoo's organizational culture. Yahoo had become overly bureaucratic and lost the zeal characteristic of high-tech startups. Many Yahoo employees worked from home. For those who worked in the office, weekends began Thursday afternoons, leaving empty parking garages at Yahoo's campus in Sunnyvale, California. In response, Mayer withdrew the option to work remotely. All of Yahoo's 12,000 employees would have to come to the office. Her rationale was that working in the same shared space encourages collaboration, teamwork, and the creative spark to foster innovation. She moved out of her corner office and instead worked in a cubicle among other Yahoo rank-and-file employees. To ease the transition into now being required to work on the Yahoo campus in Sunnyvale, California, Mayer ordered a renovation and upgrade to Yahoo's cafeteria, making gourmet meals—breakfast, lunch, and dinner—available free for all Yahoos.

Mayer also implemented other less-than-popular changes. Where before Yahoos enjoyed a casual work culture, now they faced a stacked ranking system of employee performance. Managers had to grade their direct reports along a bell curve, with a fixed percentage as “underperforming.” Team leaders were now to rank their employees in defined groups: 10 percent in “greatly exceeds,” 25 percent in “exceeds,” 50 percent in “achieves,” 10 percent in “occasionally misses,” and 5 percent in “misses.” Unintended consequences ensued. High performers refused to work with one

another in the same team. Managers cynically traded team members to fill their quotas. Political infighting increased.

To raise cash, Mayer sold part of Yahoo's ownership stake in Alibaba, the Chinese ecommerce company, for more than \$6 billion. She then spent about \$2 billion acquiring more than three dozen tech ventures, including paying a bit over \$1 billion for microblogging and social networking site Tumblr and \$640 million for video ad company BrightRoll. The acquisitions filled gaps in product line and brought in new engineering talent (so-called “aqui-hires”).

To turn around Yahoo, Mayer identified four strategic growth areas for investing significant resources and attention: mobile advertising, video, native advertising, and social media.¹ Mayer came up with the catchy phrase for the four areas: *MaVeNS* (= mobile advertising, video, native advertising, and social media), which she enjoyed using during investor presentations and earnings calls.

Failed Turnaround at Yahoo

After five years on the job, it became apparent that Yahoo would no longer be able to compete against Google and Facebook in online advertising. Once a leader in online advertising in the Web 1.0 portal world, Yahoo had fallen to third place well before Mayer took charge. Yahoo once owned the user experience in the early days of the internet for desktop users. But much has changed. In the early days, the internet was cumbersome to use. Yahoo provided a web portal that solved this problem for millions of users worldwide. It was their first stop once they logged in. With successful Yahoo products like Yahoo Mail, Yahoo Finance, and Yahoo Sports, many users spent their entire time online at Yahoo. In the first decade of the internet, this made Yahoo extremely attractive for online advertisers.

By 2012, however, the internet had undergone a dramatic shift from the Web 1.0 on personal computers to a Web 2.0 on mobile devices. The mobile experience, and with it mobile advertising, had become the new frontier. The difficulty that Mayer encountered as the new Yahoo CEO was that Google and Facebook had moved much faster and more successfully into the mobile space and thus captured the lion share of advertising. Google had long been the undisputed leader in online search due to its superior page rank algorithm technology over Yahoo's older and less effective keyword-based searches. Since 2009, Yahoo's searches

were powered by Microsoft's Bing. In addition, newer social media platforms such as Facebook captured online users' attention and activities. With these changes, Google and Facebook started to dominate digital advertising. In 2016, Google captured 43 percent of all ad dollars spent, and Facebook captured 15 percent. In online advertising, Yahoo only had 3 percent market share, which had been declining consistently over time.

To complicate matters for CEO Mayer, Yahoo experienced two major data hacks under her watch. In 2013, data for more than 1 billion accounts were stolen, the largest corporate hack on record. A year later, Yahoo disclosed a second hack, this time affecting some 500 million users. As a result, Yahoo required all of its users to reset their passwords; many did not return. In the end, Verizon acquired Yahoo's core internet business for \$4.5 billion.

Why did Verizon acquire Yahoo's core internet business? Verizon's core business as a wireless service provider is maturing, and the company has ambitious plans to compete with Google and Facebook in online advertising. Verizon is adding the Yahoo acquisition to its prior purchase of the online media company AOL in 2015 for \$4.4 billion. Verizon has more than 110 million wireless subscribers. It hopes to build a portfolio of internet properties by merging AOL and Yahoo to offer news, sports, and finance against which to sell better targeted digital advertising. After the sale of Yahoo's core business to Verizon, Yahoo's shareholders continue to own the investments made earlier by Yahoo in the Chinese ecommerce company Alibaba as well as in Yahoo Japan, valued jointly at more than \$40 billion. Verizon retained the name Yahoo for its web properties, while the "original Yahoo" renamed itself Altaba (a portmanteau of "Alternate" and "Alibaba").

Although Marissa Mayer failed to turn Yahoo around, she did create shareholder value when compared to the dire situation Yahoo was in when she took the helm. Indeed, by the time Yahoo sold its core business to Verizon, the internet company's market value had almost tripled. Mayer also did well for herself: She departed Yahoo with some \$230 million in total compensation for the five years as CEO.

DISCUSSION QUESTIONS

1. In an attempt to turn around Yahoo, Marissa Mayer defined a new mission for the internet company. How do strategic leaders such as Mayer develop and implement a mission for their company to achieve strategic goals? Why is an inspiring mission important?
2. What were some of the major changes Mayer implemented to turn Yahoo around? How do you evaluate them? In hindsight, what should Mayer have done differently, if anything? Explain.
3. What grade would you give Mayer for her job performance as strategic leader? What were her strengths and her weaknesses?
4. Where would you place her on the Level-5 pyramid of strategic leaders (see Exhibit 2.2) and why? Support your answers.
5. Do you believe the \$230 million in total compensation was justified for Mayer's efforts? Why or why not? Explain.

Endnote

1. Native advertising is online advertising that attempts to present itself as naturally occurring editorial content rather than a search-driven paid placement.

Sources: Detailed background on Yahoo, Marissa Mayer, Google, and the online advertising and search industry is presented in the following books: Carlson, N. (2015), *Marissa Mayer and the Fight to Save Yahoo!* (New York: Hachette Book Group); Thiel, P. (2014), *Zero to One. Notes on Startups or How to Build the Future* (New York: Crown Business); Edwards, D. (2012), *I'm Feeling Lucky: The Confessions of Google Employee Number 59* (New York: Houghton Mifflin Harcourt); and Levy, S. (2011), *In the Plex: How Google Thinks, Works, and Shapes Our Lives* (New York: Simon & Schuster). Other sources include: Seetharaman, D. (2017, Apr. 25), "Yahoo's Marissa Mayer to reap \$187 million after Verizon deal," *The Wall Street Journal*, Knutson, R. (2017, Feb. 21), "Why Verizon decided to stick with Yahoo deal after big data breaches," *The Wall Street Journal*, Goel, V., and M.J. de la Merced (2016, July 24), "Yahoo's sale to Verizon ends an era for a web pioneer," *The New York Times*, "Yahoo to spin off remaining Alibaba stake," *The Wall Street Journal*, January 28, 2015; "Yahoo sales, profit gains may allay Mayer critics," *The Wall Street Journal*, October 22, 2014; Jackson, E. (2014, Oct. 19), "Yahoo CEO set to refresh turnaround plan," *The Wall Street Journal*, "Alibaba IPO to give Yahoo windfall," *The Wall Street Journal*, September 19, 2014; "How do you solve a problem like Marissa?" *Forbes*, July 29, 2014; "Is Alibaba or SoftBank about to buy Yahoo?" *Forbes*, July 23, 2014; "Mayer culpa," *The Economist*, March 2, 2013; "A makeover made in Google's image," *The Wall Street Journal*, August 9, 2012; "Google's Marissa Mayer," *Vogue*, March 28, 2012; and "Yahoo Annual Reports" (various years), www.sec.gov.

MiniCase 4

How the Strategy Process Killed Innovation at Microsoft

SINCE MICROSOFT LAUNCHED Windows 3.0 in 1990, it has dominated the industry for PC operating system (OS) software with a 90 percent market share. Microsoft's huge installed base of Windows operating systems on PCs and its long-term relationships with original equipment manufacturers (OEMs), such as Dell, HP, and Lenovo, create tremendous entry barriers for newcomers. Intel's semiconductor chips are the perfect complement to Microsoft's operating system. Every time Microsoft releases a new operating system, demand for Intel's latest microprocessor goes up, because new operating systems require more computing power. Because of the complementary nature of their products, Microsoft's and Intel's alternating advances have created a virtuous cycle, benefiting from network effects. The successful combination of Microsoft's Windows and Intel's processors has produced the *Wintel* (a portmanteau of Windows and Intel) standard in the PC industry. By 1999, Microsoft was the most valuable company on the planet.

Fast-forward to 2017, two years after Microsoft released Windows 10, its latest version of the ubiquitous operating system. For the past quarter century, Microsoft's business model was to establish and maintain the dominance of the *Wintel* standard in the PC industry. With this standard, Microsoft made money off consumer and business application software such as its Office Suite. Microsoft remains hugely profitable: With some \$85 billion in annual revenues in 2016, it generated over \$20 billion in profits! Windows and Office still generate about 40 percent of Microsoft's total revenues and 75 percent of profits. The gross margin of "classic" Office is 90 percent, while the new cloud-based Office 365 only has a 50 percent profit margin.

Although Microsoft is highly profitable, its stock price was flat through the 2000s, trailing the tech-heavy NASDAQ-100 by a wide margin. This started to change even before Satya Nadella became CEO in 2014, but under Nadella's strategic focus of "mobile first, cloud first," Microsoft's stock market valuation has appreciated rapidly in recent years, in fact, more than doubling over a recent five-year period. Yet Microsoft is having to work hard for its performance



Zune, Microsoft's (failed) digital media player.
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to match that of other tech companies such as Google, Apple, and Amazon because they created entirely new areas of computing from scratch, and as a consequence, their stock prices have soared. One reason Microsoft's fell and flattened in the 2000s was that it saw its mission differently. Protecting its existing portfolio, Microsoft largely failed to commercialize any category-defining products or services. Why? The answer: Microsoft's strategy process killed innovation!

Top-Down Strategy Process Killed Bottom-Up Strategic Initiatives at Microsoft

Microsoft actually came up with some major breakthroughs, but failed to successfully commercialize them. The root of the problem seemed to lie with Microsoft's top-down strategy process. Once Windows became the industry standard in 1990, Microsoft's strategy was defensive: Any new product or extension had to strengthen the existing Windows-Office franchise; if not, it would be "killed." Here are some great products and services that Microsoft invented, but never commercialized.

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ONLINE SEARCH. Google is now the leading search and online advertising company, with close to \$100 billion in annual revenues and a market capitalization of some \$700 billion in 2017, making it one of the most valuable companies globally. What haunts former Microsoft CEO Steve Ballmer is that Microsoft had its own working prototype of a Google forerunner, called Keywords, long before Google's ascent.

Scott Banister, then a student at the University of Illinois at Urbana-Champaign, had come up with the idea of adding paid advertisements to internet searches. He quit college and drove his Geo hatchback to the San Francisco Bay Area to start Keywords, later joining an online ad company called LinkExchange. In 1998, incidentally the year Google was founded, Microsoft bought LinkExchange for some \$265 million. The newly formed Microsoft online search team urged top managers to continue to invest in the burgeoning online search technology. Instead, Microsoft executives shut down the project in 2000 because they did not see a viable business model in it. One team member actually approached Ballmer and explained that he thought Microsoft was making a huge mistake. But Ballmer said he wanted to manage through delegation and would not reverse a decision made by managers three levels below him. This decision put an end to Microsoft's first online advertising venture.

In 2003, Microsoft got a second chance to enter the online advertising business when some mid-level engineers proposed buying Overture Services, an innovator in combining internet searches with advertisements. This time, Ballmer, joined by Microsoft co-founder Bill Gates, decided not to pursue the idea because they thought Overture was overpriced. Shortly thereafter, Yahoo bought Overture for \$1.6 billion. In 2008, Ballmer offered to buy Yahoo for close to \$50 billion to help his company gain a foothold in the paid-search business where Google rules. Fortunately for Microsoft, the offer was turned down by Yahoo, which was sold for \$4.5 billion to Verizon in 2017.

Having missed two huge opportunities to pursue promising strategic initiatives that emerged from lower levels within the firm, Microsoft has been playing catch-up in online search and advertising ever since. In the summer of 2009, after spending billions of dollars and being about a decade late, it launched its own search engine, Bing. Industry pundits joked that Bing is an acronym for "Because It's Not Google."

PORTABLE MUSIC PLAYER. In 2001, Apple launched the iPod, a portable music player, with which the floundering company's resurgence began. This was followed up in 2003 by the launch of iTunes Music Store with 200,000 songs at 99 cents each. The iPod and iTunes laid the foundation of Apple's hugely successful

ecosystem tightly integrating software, hardware, and services. In 2005, during an employee meeting, one Microsoft engineer asked Steve Ballmer whether Microsoft should compete with Apple's iPod and iTunes. In a sarcastic tone, Ballmer asked the room for a show of hands, "How many people think Microsoft is in the business of selling music?"¹ Not surprisingly, none of the intimidated Microsoft employees raised their hands. More than a year later, Microsoft introduced its own digital music player, the Zune (see photo above), which flopped.

TABLET COMPUTERS. Long before Apple launched the iPad in early 2010, the inventor of Microsoft's highly successful Xbox gaming console had developed a tablet computer called the Courier. The Courier was a fully functioning tablet that folded like a book and allowed users to draw on a touchscreen, among other features. Rather than compete against Apple, Ballmer informed the Courier team that he was pulling the plug on the tablet to redirect resources to the next version of Windows, the launch for which was more than two years away. To add insult to injury, it was Windows 8, Microsoft's failed attempt to straddle desktop and mobile computing.

In the meantime, Apple had sold more than 250 million iPads, which have been instrumental in strengthening Apple's ecosystem. This ecosystem allows Apple to be the world's leader in mobile computing. (One other mobile computing invention that Microsoft killed was wearable devices such as smart watches.)

OFFICE FOR IPHONE. As soon as Apple released the iPhone in 2007, Microsoft engineers tweaked the company's PC-based Office Suite to run on the Apple mobile device. Ballmer shut the project down—he had a visceral disdain for Apple, once stomping on an iPhone in an all-employee meeting when he saw a subordinate using the popular Apple device—telling the group that Microsoft needed to focus its resources on Windows 8.

In the meantime, Apple has garnered over \$1.2 billion in iPhone sales since it was launched in 2007, making it one of the most successful products ever. In 2017, the average price for an iPhone was close to \$700. Apple's 10th anniversary phone, the iPhone X, is the first smartphone to cross the \$1,000 price threshold. Although Apple holds some 15 percent market share in the smartphone industry, it captures more than 90 percent of the profits. A whopping two-thirds of Apple's annual revenues of some \$220 billion is from iPhone sales, surely sufficient to have paid a handsome licensing fee for a Microsoft Office Suite for the iPhone.

CLOUD-BASED OFFICE SOFTWARE. Long before cloud-based computing took off, Microsoft in 2000 developed a fully functioning suite of software applications for the web including an Office-type word-processing software called NetDocs. This project was discontinued in 2001 because Ballmer feared it would cannibalize sales of the “classic” Office suite. This opened the door for Google to offer cloud-based computing applications such as Google Docs, Google Slides, and Google Sheets, which with Google Drive and Gmail make up the core of Google’s cloud-based computing services. These in turn established Google Chrome as the dominant web browser and helped Google’s Android become the leading mobile operating system with some 80 percent market share. In contrast, Microsoft’s Windows has less than 1 percent market share in mobile computing.

CAR SOFTWARE. In the early 2000s, dozens of Microsoft engineers developed—on their own time—car software that allowed drivers to use online maps, have e-mails translated to voice and read to them, as well as play digital music. Ballmer shut the project down, arguing that Microsoft—one of the most cash-rich companies on the planet—could not afford another big bet at the moment.

Today, Tesla is as much a software and sustainable energy company as it is a car company, with a market cap of more than \$60 billion. Both Tesla and Google are proving that driverless cars (all based on software and sensors) are viable within a few years and promise to be a multibillion-dollar industry.

While still CEO, Ballmer admitted problems in Microsoft’s strategic management process—to a degree: “The biggest mistakes I claim I’ve been involved with are where I was impatient—because we didn’t have a business yet in something, we should have stayed patient.”² Ballmer, who became Microsoft’s CEO in 2000, was replaced in 2014 by Satya Nadella. Under Nadella, Microsoft has made strides in reinventing itself with a “mobile first, cloud first” strategy. Can Microsoft once again innovate successfully?

Microsoft’s strategy often gets its most critical look when it holds its developers’ conference and announces new initiatives. Even though the jury may still be out for the long term, in recent years Microsoft has been getting much better press, even as its stock evaluations rise. Pundits applaud how Microsoft is releasing, fixing, and refining products like a modern cloud company. The company has broken free of Windows platforms and gone to universal availability, sometimes jumping from device to device. And it has even found new ways to provide iOS and Android apps. In short, it appears its cloud first, mobile first approach

is allowing Microsoft to offer competitively matched experiences across consumers’ platform of choice.³

Moreover, Nadella has created a culture in which the company manages a full stack of hardware, software, and data centers, and where bottom-up innovation appears to be embraced. In fact, failure is accepted as part of that process. Microsoft has created prototype labs so new ideas can be developed and tested, and if necessary, “to fail faster.” In 2017, *The Economist* proclaimed that Microsoft has indeed transformed its culture for the better, but that getting cloud computing right remains a hard thing to do.

DISCUSSION QUESTIONS

1. Describe the strategic management process at Microsoft under CEO Steve Ballmer (2000–2014). How were strategic decisions made? What were the strengths and weaknesses of this approach? Explain in detail.
2. Although Microsoft invented some promising computing breakthroughs, and often before competitors, why did Microsoft fail to successfully commercialize them?
3. Why is it so difficult for CEOs of large and successful companies such as Microsoft to balance *exploitation*—applying current knowledge to enhance firm performance in the short term—with *exploration*—searching for new knowledge that may enhance a firm’s future performance? What are the trade-offs? How could they be reconciled?
4. In contrast, what can you infer from information in the case about the current design of Microsoft’s strategy process under Microsoft CEO Satya Nadella, who started in 2014?
5. What advice would you give Nadella in his current efforts?

Endnotes

1. Quote drawn from: “Next CEO’s biggest job: Fixing Microsoft’s culture,” *The Wall Street Journal*, August 25, 2013.
2. Quote drawn from: “Microsoft bid to beat Google builds on a history of misses,” *The Wall Street Journal*, January 16, 2009.
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MiniCase 5

Apple: The iPhone Turns 10, so What's Next?

IN 2017, THE 10TH ANNIVERSARY of the iconic iPhone, Apple became the first company whose stock market valuation crossed the \$800 billion threshold, making it the most valuable company of all time.¹ Many expect Apple to be also the first company that reaches a stock market valuation of \$1 trillion! Some 20 years earlier, Apple would likely have gone bankrupt if archival Microsoft (which enjoyed the same position with a valuation of \$615 billion in December 1999) had not invested \$150 million in Apple.

Apple got to where it is today by implementing a potent competitive strategy. That strategy, conceptualized by co-founder Steve Jobs, combines innovation in products, services, and business models. From near-bankruptcy in 1997, Apple's revitalization really took off in 2001 (see Exhibit MC5.1) when it introduced the iPod, a portable digital music player, the same year it opened its first retail stores. Apple's stores earn the highest sales per square foot of any retail outlets, including luxury stores such as jeweler Tiffany & Co. and LVMH, purveyor of fine handbags and other luxury goods.

In 2003, Apple soared even higher when it opened the online store iTunes. Apple didn't stop there. In 2007, the company revolutionized the smartphone market with the introduction of the iPhone. Just three years later, Apple created the tablet computer industry by introducing the iPad, thus beginning to reshape the publishing and media industries. Further, for each of its iPod, iPhone, and iPad lines of businesses, Apple followed up with incremental product innovations that extended each product category, culminating in the 10th anniversary edition of the iPhone launched in 2017. By combining tremendous brainpower, intellectual property, and iconic brand value, Apple has enjoyed dramatic increases in revenues, profits, and stock market valuation.

A Good Strategy

Why was Apple so successful? Why did Microsoft's once superior market valuation evaporate? Why did Apple's competitors, such as Sony, Dell, Hewlett-Packard (HP),



At Apple's new headquarters in Cupertino, California, the futuristic building emphasizes open spaces with plenty of natural light to allow for random encounters among employees to foster creativity and innovation. The building, reminiscent of a sci-fi spaceship, cost an estimated \$5 billion, making it the most expensive office space built. In front, Tim Cook, CEO Apple.

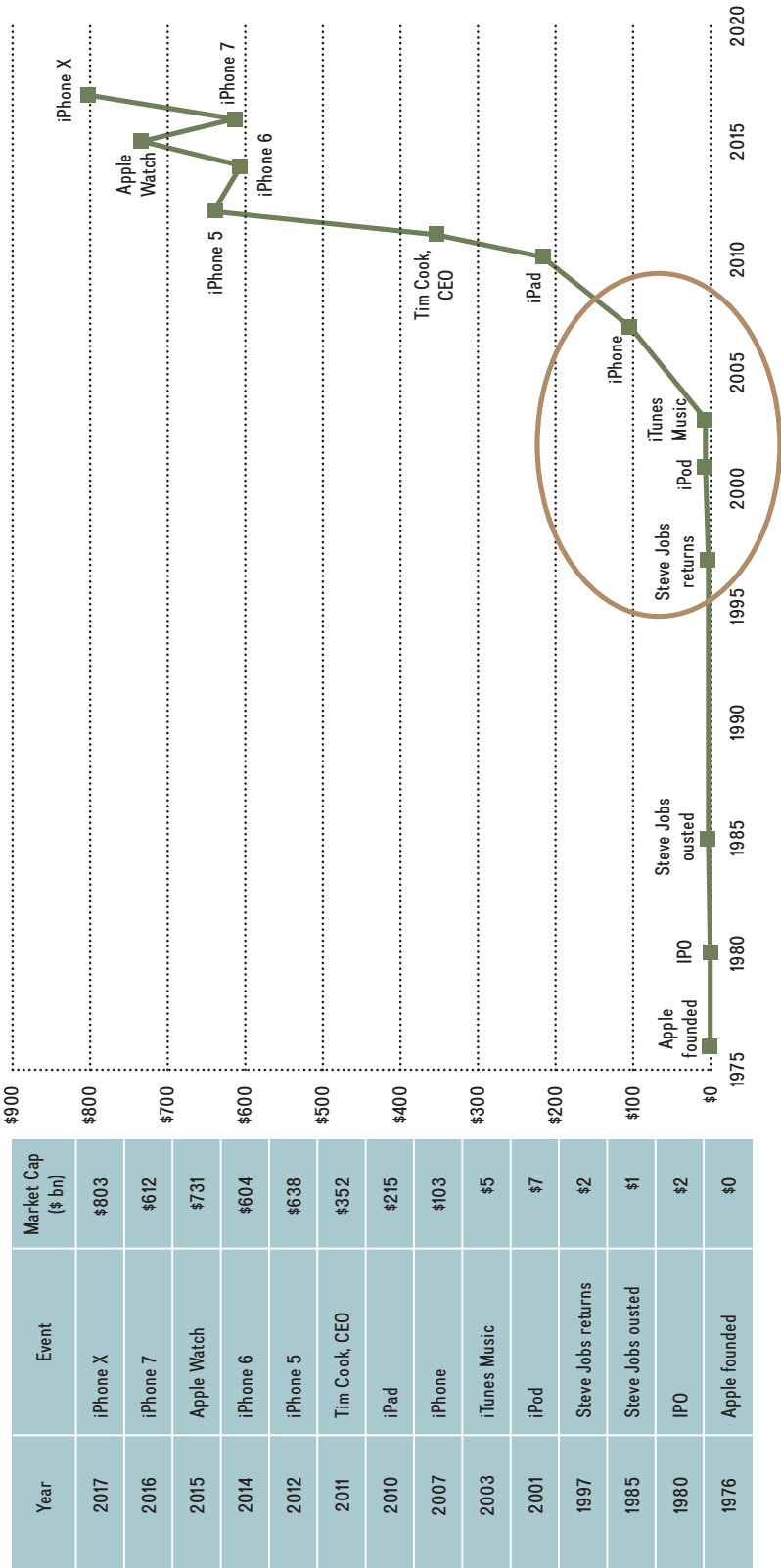
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Nokia, and BlackBerry, struggle or go out of business? The short answer is: Apple had a better strategy. But this raises the question: What is a good strategy? A good strategy is more than a mere goal or a company slogan. A good strategy defines the competitive challenges facing an organization through a critical and honest assessment of the status quo. A good strategy also provides an overarching approach (policy) on how to deal with the competitive challenges identified. Last, a good strategy requires effective implementation through a coherent set of actions. A *good strategy*, therefore, consists of three elements:²

1. A *diagnosis* of the competitive challenge.
2. A *guiding policy* to address the competitive challenge.
3. A *set of coherent actions* to implement the firm's guiding policy.

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EXHIBIT MC5.1 / Apple's Stock Market Valuation (in billions) and Key Events, 1976–2017



SOURCE: Depiction of publicly available data.

THE COMPETITIVE CHALLENGE. First, consider the diagnosis of the competitive challenge. Above, we briefly traced Apple's renewal from the year 2001, when it hit upon the product and business-model innovations of the iPod/iTunes combination. Before that, Apple was merely a niche player in the desktop-computing industry and struggling financially. Steve Jobs turned the sinking company around by focusing on only two computer models (one laptop and one desktop) in each of two market segments (the professional market and the consumer market) as opposed to dozens of non-differentiated products within each segment. This streamlining of its product lineup enhanced Apple's strategic focus. Even so, the outlook for Apple was grim. Jobs believed that Apple, with less than 5 percent market share, could not win in the personal computer industry where desktops and laptops had become commoditized gray boxes. In that world, Microsoft, Intel, and Dell were the star performers. Jobs knew that he needed to create the "next big thing."³

A GUIDING POLICY. Second, Apple shifted its competitive focus away from personal computers to mobile devices. In doing so, Apple disrupted several industries through its product and business-model innovations. Combining hardware (i.e., the iPod) with a complementary service product (i.e., the iTunes Store) enabled Apple to devise a new business model. Users could now download individual songs legally (at 99 cents) rather than buying an entire CD or downloading the songs illegally using Napster and other file-sharing services. The availability of the iTunes Store drove sales of iPods. Along with rising sales for the new iPod and iTunes products, demand rose for iMacs. The new products helped disrupt the existing personal computer market, because people wanted to manage their music and photos on a computer that worked seamlessly with their mobile devices. Apple then leveraged the success of the iPod/iTunes business-model innovation, following up with product-category-defining innovations when launching the iPhone (in 2007) and the iPad (in 2010).

COHERENT ACTIONS. Third, Apple implemented its guiding policy with a set of coherent actions. Apple's coherent actions took a two-pronged approach: It drastically streamlined its product lineup through a simple rule—"we will make only one laptop and one desktop model for each of the two markets we serve, professional and consumer." It also disrupted the industry status quo through a potent combination of

product and business-model innovations, executed at planned intervals. These actions allowed Apple to create a string of temporary competitive advantages (see Exhibit MC5.1). Taken together, this allowed Apple to sustain its superior performance for over a decade, making it the most valuable company on the planet in the process.

Past performance, however, is no guarantee of future performance. Microsoft was once the most valuable company in the world but has since struggled to keep up with Apple. At the same time, Microsoft, as well as Google, Samsung, Amazon, and others, are working hard to neutralize Apple's competitive advantage.

The trillion-dollar question is whether Apple can continue to maintain a competitive advantage in the face of increasingly strong competition and rapidly changing industry environments. In both mobile payment systems (Apple Pay launched in 2014) and music streaming (Apple Music launched in 2015), Apple was a late mover. The Apple Watch, introduced in 2015, is the first new product category Apple launched since the iPad in 2010. Although Apple continues to capture over 90 percent of profits in the smartphone industry, more than 60 percent of Apple's \$220 billion revenue comes from the iPhone. Moreover, China accounts for more than 20 percent of Apple's total revenues, a market that is becoming more and more volatile for the Cupertino, California, tech company. These are pressing issues that Apple CEO Tim Cook needs to address in order to sustain Apple's competitive advantage.

DISCUSSION QUESTIONS

1. Explain Apple's success over the past decade relative to its main competitors. Think about which industries it has disrupted and how.
2. Is Apple's success attributable to industry effects, firm effects, or a combination of both? Explain.
3. What are the greatest challenges Apple is facing? Detail them by internal weaknesses and external threats. How can Apple transform internal weaknesses into strengths, and external threats into opportunities?
4. Apply the three-step process for developing a *good strategy* outlined above (diagnose the competitive challenge, derive a guiding policy, and implement a set of coherent actions) to Apple's situation today. Which recommendations would you have for Apple to outperform its competitors in the future? Be specific.

Endnotes

1. Apple's valuation is in absolute dollars, not in real (inflation-adjusted) dollars. When adjusted for inflation since 1999, Microsoft's record market valuation would be roughly \$850 billion in 2017.

2. This discussion is based on Rumelt, R. (2011), *Good Strategy, Bad Strategy* (New York: Crown Business).

3. Rumelt, R. (2011), *Good Strategy, Bad Strategy* (New York: Crown Business), 14.

Sources: Mickle, T. (2017, June 20), "Among the iPhone's biggest transformations: Apple itself," *The Wall Street Journal*; Mickle, T. (2017, June 1), "What's driving Apple's epic valuation," *The Wall Street Journal*; "Apple earnings surge 33% on iPhone sales," *The Wall Street Journal*, April 27, 2015; "Apple, feeling

heat from Spotify, to offer streaming music service," *The Wall Street Journal*, June 1, 2015; "Apple's share of smartphone industry's profits soars to 92%," *The Wall Street Journal*, July 12, 2015; "Apple's market cap loses \$60 billion after iPhone sales disappoint," *The Wall Street Journal*, July 22, 2015; Sull, D., and K.E. Eisenhardt (2015), *Simple Rules: How to Thrive in a Complex World* (New York: Houghton Mifflin Harcourt); "Apple plans web TV service in fall," *The Wall Street Journal*, March 17, 2015; Kane, I.Y. (2014), *Haunted Empire: Apple After Steve Jobs* (New York: HarperCollins); "An iPopping phenomenon," *The Economist*, March 24, 2012; "From pipsqueak to powerhouse," *The Economist*, August 21, 2012; "iRational?" *The Economist*, March 24, 2012; "Apple market value hits record high," *The Wall Street Journal*, August 20, 2012; "GiantApple," *The Economist*, August 21, 2012; Sull, D., and K.E. Eisenhardt (2012), "Simple rules for a complex world," *Harvard Business Review*, September; Isaacson, W. (2011), *Steve Jobs* (New York: Simon & Schuster); and Rumelt, R. (2011), *Good Strategy, Bad Strategy* (New York: Crown Business).

MiniCase 6

Nike's Core Competency: The Risky Business of Creating Heroes

DURING THE LAST DECADE, Nike's annual revenues doubled and by 2018 attained some \$35 billion. With its globally recognized brand, Nike is the undisputed leader in the athletic shoe and apparel industry. Number-two adidas has some \$22 billion in sales, while recent entrant Under Armour reports revenues of \$5 billion. Nike is tremendously successful, holding close to a 60 percent market share in running shoes and nearly a 90 percent market share in basketball shoes and apparel. Yet one of its greatest strengths can also be seen as one of its greatest vulnerabilities. Before we introduce that strength, it helps to know how Nike started.

Nike Co-founders: Bill Bowerman and Phil Knight

The Beaverton, Oregon, company has come a long way from its humble beginnings. It was founded by University of Oregon track and field coach Bill Bowerman and middle-distance runner Phil Knight in 1964 and was first called Blue Ribbon Sports. In 1971, the company changed its name to Nike (Greek mythology's goddess of victory) with the now iconic "swoosh" designed by a Portland State University student.

BOWERMAN'S ROLE. Coach Bowerman was a true innovator because he constantly sought ways to give his athletes a competitive edge. He experimented with many factors affecting running performance, from different track surfaces to rehydration drinks. Bowerman's biggest focus, however, was on providing a better running shoe for his athletes. While sitting at the breakfast table one Sunday morning and absent-mindedly looking at his waffle iron, Bowerman had an epiphany. He poured hot, liquid urethane into the waffle iron—ruining it in the process but coming up with the now famous waffle-type sole that not only provided better traction but was also lighter than traditional running shoes.



Nike's sponsorship agreement with Brazil's national soccer team, seen here at the World Cup 2014 in Brazil, began in 1996 and became embroiled in the FIFA soccer scandal.

©ITAR-TASS Photo Agency/Alamy Stock Photo

ENTER KNIGHT. After completing his undergraduate degree at the University of Oregon and serving in the U.S. Army, Phil Knight entered the MBA program at Stanford. One entrepreneurship class required him to come up with a business idea. He wrote a term paper on how to disrupt the leading athletic shoemaker, adidas. The research question he came up with was, "Can Japanese sports shoes do to German sports shoes what Japanese cameras have done to German cameras?"¹

At that time, adidas athletic shoes were the gold standard. They were also expensive and hard to find in the United States. After several failed attempts to interest Japanese sneaker makers, Knight struck a distribution agreement with Tiger Shoes. After his first shipment arrived in the United States, Phil Knight sent some of the running shoes to his former coach, Bill Bowerman, hoping to make a sale. To his surprise,

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Bowerman replied that he was interested in becoming a business partner and contributing his innovative ideas on how to improve running shoes, including the waffle design. With an investment of \$500 each and a handshake, the venture commenced.

Creating Heroes

Nike had already reached a level of success by the late 1970s. Based on a highly successful string of innovations including Nike Air, by 1979 the company had captured more than a 50 percent market share for running shoes in the United States. A year later, Nike went public. Even so, the company had yet to establish one of its most effective marketing tactics.

In 1984, Nike signed Michael Jordan—still early in his career, before he was hailed by many as the greatest basketball player of all time—with an unprecedented multimillion-dollar endorsement deal. Rather than spreading its marketing budget more widely as was common in the sports industry at that time, Nike made the unorthodox move to spend basically its entire budget for a specific sport on a single star athlete. Nike sought to sponsor future superstars that embodied an unlikely success story. Michael Jordan did not make the varsity team as a junior in high school, and yet he became the greatest basketball player ever. Nike's Air Jordan basketball shoes are all-time classics that remain popular to this day.

In the 1990s and 2000s, Nike continued to sponsor track and field stars such as Marion Jones as well as Kobe Bryant in basketball. With the help of major celebrity endorsements, Nike was also able to move on to different sports and their superstars, including golf with Tiger Woods, cycling with Lance Armstrong, soccer with Wayne Rooney, and football with Michael Vick. If some of those names trigger memories of scandals as well as athletic achievements, you see the problems that Nike risks with its endorsement program. Before going into the negatives, let's examine the powerful message behind such endorsements.

Nike is less about running shoes or sports apparel than about unlocking human potential. This is captured in Nike's mission *to bring inspiration and innovation to every athlete in the world* (and *if you have a body, you are an athlete*).² Nike uses its heroes to tell a story whose moral is that through sheer will, tenacity, and hard work, *anyone* can unlock the hero within and achieve amazing things. Nike will help everyone become a hero. *Just Do It!* This type of mythical brand image has allowed Nike to not only enter but also often



Oscar Pistorius (left) and Lance Armstrong (right), some of Nike's past celebrity endorsements.

(left) ©Ian Walton/Getty Images; (right) ©Ragnar Singaas/Getty Images

dominate one sport after another, from running to ice hockey. It spends more than \$1 billion a year sponsoring athletes. Nike picks athletes that succeeded against the odds—cancer survivor Lance Armstrong, double amputee “blade runner” Oscar Pistorius, and other athletes hailing from disadvantaged backgrounds.

Nike astutely focuses on its core competency in athlete sponsorship and design, while it outsources noncore activities such as manufacturing and much of retailing. To create heroes, Nike has to engage in a number of activities: Find athletes that succeed against the odds; identify them before they are well-known superstars; sign the athletes; create products that are closely linked with the athlete; promote the athletes or teams and Nike products through TV ads and social media to create the desired image; and so on. Each activity contributes to the relative value of the product and service offering in the eyes of potential customers and the firm's relative cost position vis-à-vis its rivals. Over time, Nike developed a deep expertise in creating heroes. More importantly, having consistently better expectations of the future value of resources allows Nike not only to shape the desired image of the athlete, but also to capture some of the value these athletes create.

When Heroes Fall

Although this core competency made Nike highly successful, it has not been without considerable risks. Repeatedly, Nike's “heroes” have become unmasked as cheaters, frauds, and criminals, some of whom have committed serious felonies, such as (culpable) homicide. Long-time CEO and Chairman Phil Knight long ago declared that

scandals surrounding its superstar endorsement athletes are “part of the game.”³ So Nike appears to be comfortable in tolerating those risks, at least in some cases.

Sometimes Nike continued to sponsor its athletes involved in various scandals; other times it terminated its lucrative endorsement contracts. Nike continued to sponsor NBA star Kobe Bryant who was cleared of alleged rape charges. After Tiger Woods was engulfed in an infidelity scandal, Nike continued to sponsor the golf superstar. In 2007, Nike ended its endorsement contract with NFL quarterback Michael Vick after a public outcry and his subsequent felony conviction of running a dog-fighting ring and engaging in animal cruelty. In 2011, after serving a prison sentence and restarting his career at the Philadelphia Eagles, Nike signed a new endorsement deal with Vick. In 2012, Nike terminated its long-term relationship with disgraced cyclist Lance Armstrong. Just before Armstrong's public admission to doping in an interview with Oprah Winfrey, Knight answered, “Never say never,” when asked if Nike would sponsor Armstrong again in the future. In 2013, Nike removed its ads with Oscar Pistorius and the unfortunate tagline “I am the bullet in the chamber,” after the South African track and field athlete was charged with homicide.

In 2014, Nike got entangled in the FIFA (the world governing body of soccer) bribery scandal. It began 20 years earlier when Nike decided to gain a stronger presence in soccer after the 1994 World Cup was held in the United States. In 1996, Nike signed a long-term sponsorship agreement with the Brazilian national team worth hundreds of millions of dollars. This was a huge win for Nike because soccer has been the basis of adidas' success, much like running and basketball has been for Nike. Moreover, Brazil won the tournament five times (more than any other nation) and is the only team to have played in every tournament, which is only held every four years.

Nike is now alleged to have paid some \$30 million to a middleman, who used that money for bribing soccer officials and politicians in Brazil. This middleman—Jose Hawilla—has admitted a number of crimes including fraud, money laundering, and extortion related to the FIFA soccer investigation by U.S. prosecutors.

Time and time again Nike's heroes have fallen from grace, and the company itself has fallen under suspicion

of wrongdoing. Clearly, Nike's approach in building its core competency of creating heroes is not without risks. Too many of these public relations disasters combined with too severe shortcomings of some of Nike's most celebrated heroes could damage the company's reputation and lead to a loss of competitive advantage. As Nike veers from one public relations disaster to the next, disappointment with the brand and its promise may eventually set in, causing customers to go elsewhere.

DISCUSSION QUESTIONS

1. The MiniCase indicates that Nike's core competency is to create heroes. What does this mean? How did Nike build its core competency? Does it, for example, identify and leverage the potential identified in a *VRIO* analysis (are its competencies valuable, rare, inimitable, and organized to capture value) in a resource-based view of the firm?
2. What would it take for Nike's approach to turn from a strength into a weakness? Did this tipping point already occur? Why or why not?
3. What recommendations would you have for Nike? Can you identify a way to reframe the competency of creating heroes? Or a new way to think of heroes, teams, or sports that would continue to build the brand?
4. If you are a competitor of Nike (such as adidas, Under Armour, New Balance, or Li-Ning), how could you exploit Nike's apparent vulnerability? Provide a set of concrete recommendations.

Endnotes

1. As quoted in: “Knight the king: The founding of Nike,” *Harvard Business School Case Study*, 9-810-077, 2.
2. http://help-en-us.nike.com/app/answers/detail/a_id/113/p/3897.
3. According to Reuters, cited in: www.sportbusiness.com, December 15, 2009.

Sources: Germano, S. (2017, June 15), “Nike to cut jobs as it combats sneaker slump,” *The Wall Street Journal*, Stevens, L., and S. Germano (2017, June 28), “Nike thought it didn't need Amazon—then the ground shifted,” *The Wall Street Journal*, “Nike's bold push into soccer entangled it in FIFA probe,” *The Wall Street Journal*, June 4, 2015; “The big business of fairy tales,” *The Wall Street Journal*, February 14, 2013; Sachs, J. (2012), *Winning the Story Wars* (Boston, MA: Harvard Business School Press); Nike, Inc., *History and Heritage*, <http://nikeinc.com/pages/history-heritage>; and Halberstam, D. (2000), *Playing for Keeps: Michael Jordan and the World* (New York: Broadway Books).

MiniCase 7

Dynamic Capabilities at IBM

"You make the right decision for the long run. You manage for the long run, and you continue to move to higher value. That's what I think my job is."¹

LED BY CEO Virginia Rometty, the IBM of today is an agile and nimble IT services company. Rometty was promoted to CEO in 2012 from her position as senior vice president of sales, marketing, and strategy. Rather than facing just one technological transformation, IBM and its clients are currently facing three disruptions at once:

1. *Cloud computing:* By providing convenient, on-demand network access to shared computing resources such as networks, servers, storage, applications, and services, IBM attempts to put itself at the front of a trend now readily apparent in services that include Google Drive, Dropbox, or Microsoft 365. Increasingly, businesses are renting computer services rather than owning hardware and software and running their own networks. One of the largest cloud-computing providers for businesses is Amazon Web Services (AWS), which beat out IBM in winning a high-profile CIA contract. This was seen as a major embarrassment given IBM's long history of federal contracts. Microsoft with its Azure cloud offering is another potent competitor, especially after CEO Satya Nadella focused Microsoft on a "cloud first, mobile first" strategy.
2. *Systems of engagement:* IBM now helps businesses with their systems of engagement, a term the company uses broadly to cover the transition from enterprise systems to decentralized systems or mobility. IBM identifies the traditional enterprise system as a "system of record" that passively provides information to the enterprise's knowledge workers. It contrasts that with systems of engagement that provide mobile computing platforms, often including social media apps such as Facebook or Twitter, that promote rapid and active collaboration. To drive adoption of mobile computing for



Virginia Rometty, IBM chief executive officer. ©JEWEL SAMAD/AFP/Getty Images

business, IBM partnered with Apple to provide business productivity apps on Apple devices.

3. *Big data and analytics:* IBM now offers smarter analytics solutions that focus on how to acquire, process, store, manage, analyze, and visualize data arriving at high volume, velocity, and variety. Prime applications are in finance, medicine, law, and many other professional fields relying on deep domain expertise within fast-moving environments. IBM partnered with Twitter to provide IBM's business clients big data and analytics solutions in real time based on the vast amount of data produced on Twitter.

IBM's Core Competency: Providing Solutions

At its core, IBM is a solutions company. It solves data-based problems for its business clients, but the technology and problems both change over time. As an example,

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IBM helped kick-start the PC revolution in 1981 by setting an open standard in the computer industry with the introduction of the IBM PC running on an Intel 8088 chip and a Microsoft operating system (MS-DOS). Ironically, in the years following, IBM nearly vanished after experiencing the full force of that revolution, because its executives believed that the future of computing lay in mainframes and minicomputers that would be produced by fully integrated companies. However, with an open standard in personal computing, the entire industry value chain disintegrated, and many new firms entered its different stages. This led to a strategic misfit for IBM, which resulted in a competitive disadvantage.

Rather than breaking up IBM into independent businesses, Lou Gerstner, installed as CEO in 1993, refocused the company on satisfying market needs, which demanded sophisticated IT services. Keeping IBM together as one entity allowed Gerstner to integrate hardware, software, and services to provide sophisticated solutions to customers' IT challenges. IBM was quick to capitalize on the emergence of the internet to add further value to its business solutions. The company also moved quickly to sell its PC business to Lenovo, a Chinese tech company, in 2005 when substitution from tablet computers was just beginning to impact demand. In 2014, IBM followed up on this transaction with the sale of its server business also to Lenovo.

Exhibit MC7.1 shows IBM's dynamic capability to successfully transform itself multiple times over its more than 100-year history—a history with periods of major disruptions in the data information industry, from mechanical calculators to the internet. In contrast to IBM, note how at the bottom of Exhibit MC7.1, strong competitors in one period drop from significance when a new wave of technology emerges.

Challenges Ahead

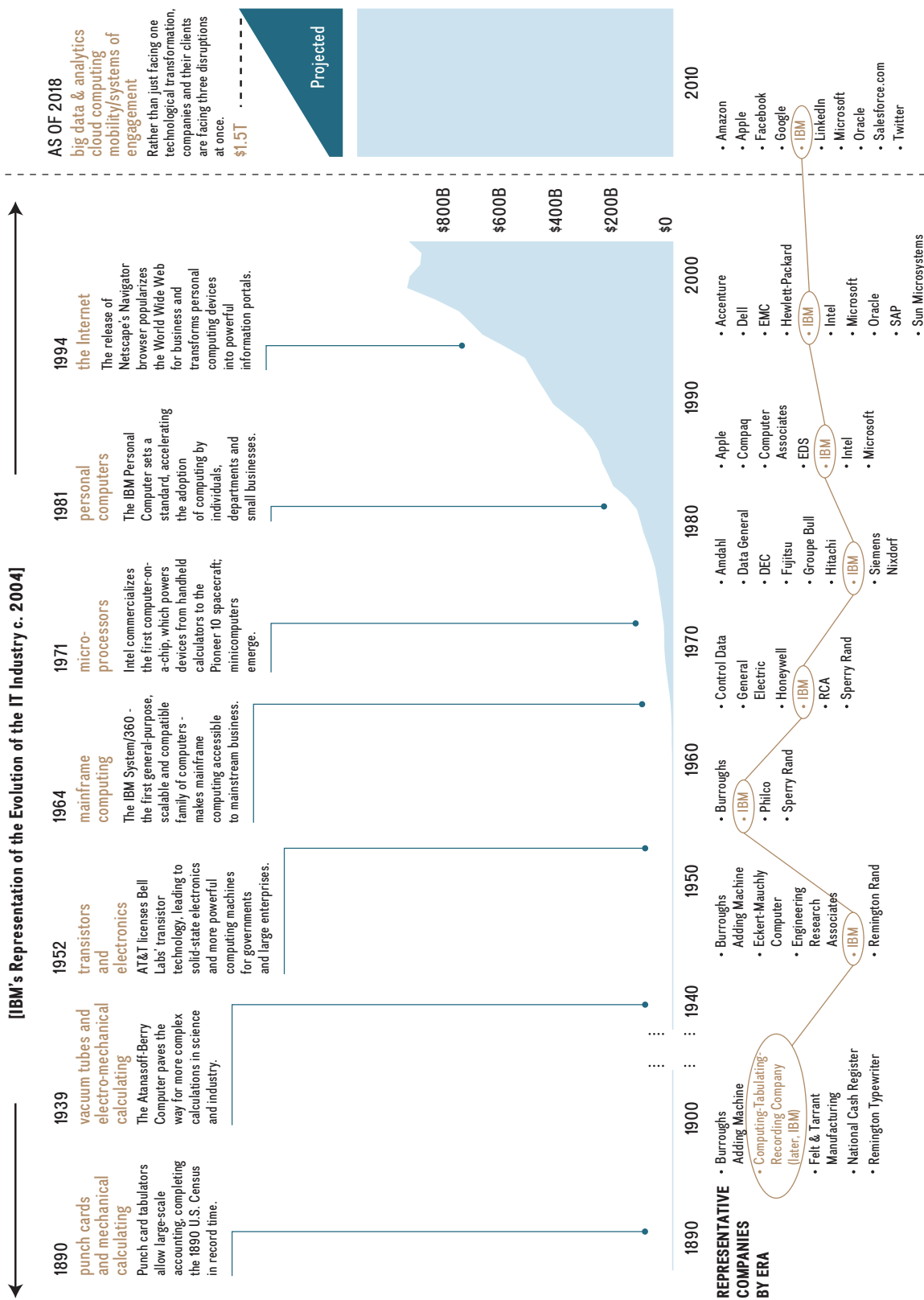
Critics of Rometty's strategic approach, including the activist investor Mark Cuban, point out that IBM was slow to take advantage of these mega-opportunities, and they continue to watch IBM's stock performance with skepticism. The critics grew louder when Rometty received a pay increase and a \$3.6 million bonus for her 2014 performance, during which revenue dropped about 6 percent and net income 27 percent. Overall, IBM's market cap plummeted by 50 percent: from a high of \$240 billion in the spring of 2013

to some \$120 billion early in 2016. And revenues for IBM have fallen for five straight years, from a high of \$107 billion when Rometty became CEO to \$78 billion in 2017. During the same period, IBM's (normalized) stock price fell by more than 30 percent, while the tech-heavy NASDAQ-100 index rose by over 110 percent during the same period. Thus, IBM is clearly underperforming the wider market by a huge margin and has done so for quite some time. Some critics even go so far as to call for a replacement of Rometty.

Rometty, however, stays committed to IBM's new strategic focus and argues that she is transforming IBM for the long run. She views the most recent waves of technology disruptions as creating major business opportunities and has made sure that IBM invests heavily to take advantage of them. IBM has trained all of its consultants—over 100,000—in these three areas to help its business clients with their own transformation. Moreover, Rometty ended the option of IBM employees to work from home. In an attempt to foster innovation through co-location, she gave all IBM employees a choice: Start working from a regional office Monday through Friday, or leave the company. This came as a shock to many IBM employees as it has been a pioneer in providing telecommute options for its employees for decades. Indeed, IBM's strategic initiative of "the anytime, anywhere workforce" was extremely popular among its employees. Until recently, IBM believed that a distributed workforce, with many employees working from home, allowed it to further perfect the technology solutions it was providing for its customers with similarly distributed workforces.

DISCUSSION QUESTIONS

1. Why has IBM been underperforming the broader technology market for several years now? What are the reasons for its sustained competitive disadvantage?
2. Describe the three current transformations that IBM is facing. What causes these transformations? Who are the main competitors?
3. What are dynamic capabilities? Explain. Looking at IBM's track record of technological transformation depicted in Exhibit MC7.1, which role did dynamic capabilities play in these successful transformations?



SOURCE: IBM Prospectus (2004), "Evolution of the IT Industry," Understanding Our Company," 5. Vertical axis shows total industry revenues. IBM relied on industry growth data from IDC (2004), 40 Years of IT: Looking Back, Looking Ahead, An IDC Special Edition Executive Whitepaper, John Gantz, chief research officer, and IBM's own records. Information in the last column to the right derives (research and depiction of 2018 wave) from author's analysis and estimate of industry growth from various sources. Visual emphasis added to IBM to show its ongoing competitive standing.

4. Do you believe that IBM is likely to master the current three-pronged tech transformation as identified? Why or why not? Explain.
5. IBM's decision to end greater work flexibility and require co-location of employees in the office was met with some consternation. How do you see IBM's decision, and what are likely positive and negative consequences?

Endnote

1. As quoted in: Lohr, S. (2014, May 13), "IBM's Virginia Rometty on leadership and management," *The New York Times*,

Sources: Simons, J. (2017, May 18), "IBM, a pioneer of remote work, calls workers back to the office," *The Wall Street Journal*; McMillan, R. (2016, Jan. 28), "IBM CEO Rometty getting \$4.5 million bonus for 2015," *The Wall Street Journal*; Langley, M. (2015, Apr. 20), "Behind Ginni Rometty's plan to reboot IBM," *The Wall Street Journal*; "Systems of engagement and the enterprise," IBM website; Hiltzik, M. (2015, Feb. 2), "IBM redefines failure as 'success,' gives underachieving CEO huge raise," *Los Angeles Times*, February 2; Belvedere, M. (2014, Oct. 22), "IBM no longer a tech company: Mark Cuban," *CNBC*; Goldman, D. (2011, Oct. 25), "IBM CEO Sam Palmisano to step down," *CNN Money*; Harreld, J.B., C.A. O'Reilly, and M. Tushman (2007), "Dynamic capabilities at IBM: Driving strategy into action," *California Management Review* 49: 21–43; Gerstner, L.V. (2002), *Who Says Elephants Can't Dance?* (New York: HarperBusiness); Grove, A.S. (1996), *Only the Paranoid Survive: How to Exploit the Crisis Points that Challenge Every Company and Every Career* (New York: Currency Doubleday); and various resources at ibm.com and IBM annual reports (diverse years).

MiniCase 8

Starbucks after Schultz: How to Sustain a Competitive Advantage?

INSPIRED BY ITALIAN coffee bars, Starbucks CEO Howard Schultz set out to provide a completely new consumer experience. The trademark of any Starbucks is its ambience—where music and comfortable chairs and sofas encourage customers to sit and enjoy their beverages and, more recently, food and (at some locations) even wine. Customers can use the complimentary wireless service or just visit with friends. The barista seems to speak a foreign language as she rattles off the offerings: Caffé Misto, Caramel Macchiato, Cinnamon Dolce Latte, Espresso Con Panna, or Mint Mocha Chip Frappuccino, among some 30 different coffee blends. Dazzled and enchanted, customers pay \$4 or more for a venti-sized drink. Starbucks has been so successful in creating its ambience that customers keep coming back for more.

Starbucks' core competency is to create a unique consumer experience the world over. Schultz' strategic intent was to create a "third place," between home and work, where people wanted to visit, ideally daily. Customers are paying for the unique experience and ambience, not just for the cup of coffee. The consumer experience that Starbucks created is a valuable, rare, and costly to imitate intangible resource. This allowed Starbucks to gain a competitive advantage. Since 2000, Starbucks' revenues have grown almost 15-fold, from less than \$2 billion to some \$27 billion in 2017.

While core competencies are often built through learning from experience, they can atrophy through forgetting. This is what happened to Starbucks. Between 2004 and 2008, Starbucks expanded operations rapidly by doubling the number of stores from 8,500 to almost 17,000 stores (see Exhibit MC8.1). It also branched out into ice cream, desserts, sandwiches, books, music, and other retail merchandise, straying from its core business.

Trying to keep up with its explosive growth in both number of stores and product offerings, Starbucks began to forget what made it unique. It lost the appeal that made it special, and its unique culture got diluted.

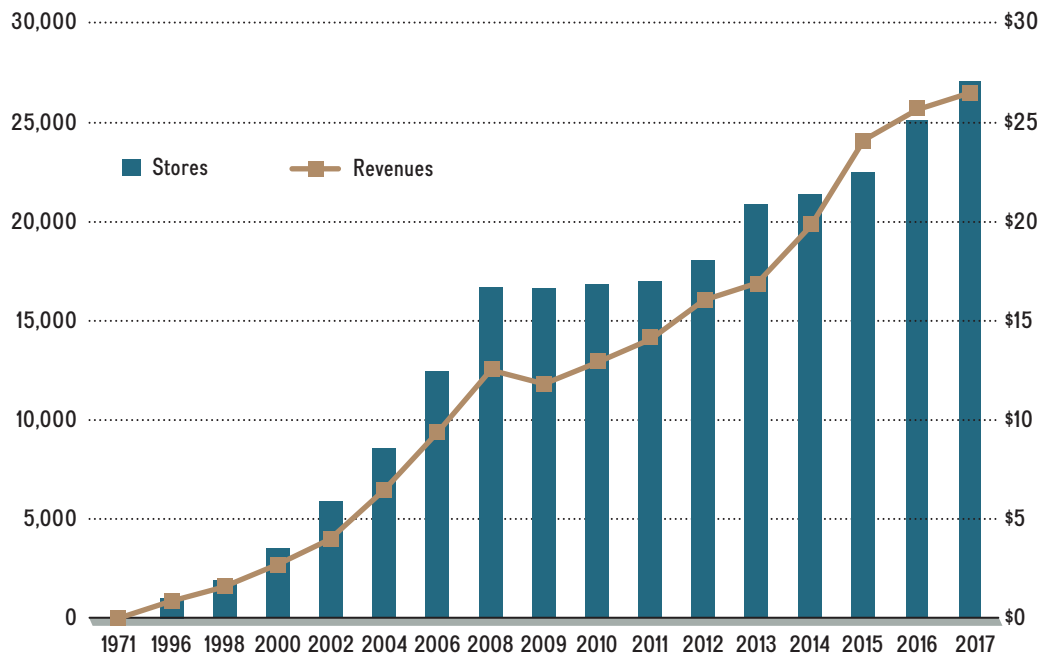


China represents a significant future growth opportunity for Starbucks, assuming it can transfer its core competency successfully.

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For example, baristas used to grind beans throughout the day whenever a new pot of coffee had to be brewed (which was at least every eight minutes). The grinding sounds and fresh coffee aroma were trademarks of Starbucks stores. Instead, to accommodate its fast growth, many baristas began to grind all of the day's coffee beans early in the morning and store them for the rest of the day. New espresso machines, designed for efficiency, were so tall that they physically blocked interaction between baristas and customers. Although these and other operations changes allowed Starbucks to reduce costs and improve efficiency, they undercut Starbucks' primary reason for success—that going to Starbucks was not simply a stop for caffeine; it was a sensory experience. The negative impact of

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EXHIBIT MC8.1 / Total Number of Starbucks Stores and Revenues (\$ billions), 1971–2017

SOURCE: Depiction of data drawn from various Starbucks annual reports.

cost-reduction measures was underscored when Starbucks lost a blind taste-test to fast food giant McDonald's. Among six coffees tested, Starbucks came in last. Even run-of-the-mill supermarket coffees sold in huge cans were rated higher. Some customers don't like Starbucks coffee and gave the chain the nickname "Charbucks"—because critics say that a lot of the coffee has an overly roasted quality, a dark and bitter taste.

To make matters worse, the global financial crisis (2008–2009) hit Starbucks hard. The first items consumers go without during recession are luxury items such as a \$4 coffee at Starbucks (see revenue drop in Exhibit MC8.1).

Coming out of an eight-year retirement, Howard Schultz again took the reins as CEO in January 2008, attempting to re-create what had made Starbucks special. He immediately launched several strategic initiatives to turn the company around. Just a month after coming back, Schultz ordered more than 7,000 Starbucks stores across the United States to close for one day so that baristas could learn the perfect way to prepare coffee. The company lost over \$6 million in revenue on that one day. This exacerbated investor jitters, but Schultz felt the importance of relearning

how to create a unique Starbucks experience was key to bringing back its corporate culture.

In 2009, Starbucks introduced Via, its new instant coffee, a move that some worried might further dilute the brand. In 2010, Schultz rolled out new customer service guidelines: Baristas would no longer multitask, making multiple drinks at the same time, but would instead focus on no more than two drinks at a time, starting a second one while finishing the first. Schultz also focused on readjusting store managers' goals. Before Schultz' return, managers had been given a mandate to focus on sales growth. Schultz, however, knew that Starbucks' main differentiator was its special customer experience. The CEO instructed managers to focus on what had made the Starbucks brand successful in the first place.

Although its earlier attempt to diversify away from its core business in the mid-2000s failed, under Schultz, Starbucks was able to successfully introduce food items. Attempting to drive more store traffic in other than the morning hours where customers need their daily caffeine shot, the chain has added baked goods, sandwiches, and other food items to its menu. To get more customers into its stores in the late afternoon and early

evening—traditionally its slowest time—Starbucks stores now offer items such as vegetables, flatbread pizza, plates of cheese, and desserts. It even introduced alcoholic beverages such as wine and beer, available after 4 p.m., as part of an “Evenings” program.

Starbucks also continues its efforts to find new levels of luxury offerings catering to higher end customers within its existing customer base. Online and in stores it produces limited-run exclusive batches of varietal coffees for home use, at high price points. Some stores also offer individually brewed cups of the same higher-priced roasts. Since 2014 Starbucks has created something called a Starbucks Reserve Roastery and Tasting Room. The first of super high-end stores appeared in Starbucks’ home, in Seattle, with more planned domestically and around the world.

Most of these initiatives continue. It has retooled its Evenings program of alcohol, for example, and in 2017 announced such offerings would be scaled back to continue only at its Roastery locations. Otherwise its ambitions continue. Starbucks’ goal is to double its revenues from food over the next few years and to be seen as an evening food-and-wine destination. To symbolize its transition from a traditional coffeehouse, Starbucks dropped the word *coffee* from its logo.

Schultz also pushed the adoption of new technology to engage with customers more intimately and effectively. Starbucks now uses social media

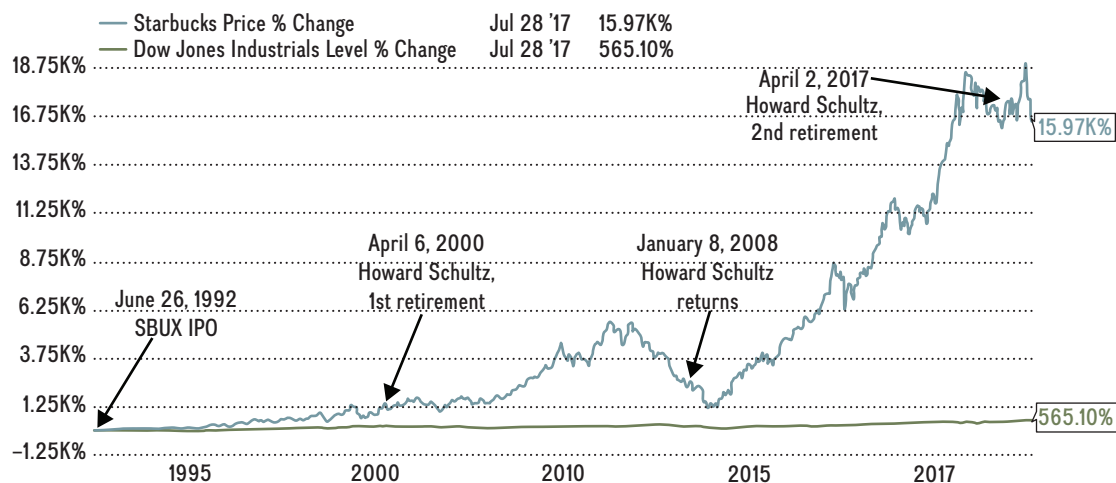
platforms Facebook and Twitter to communicate with customers more or less in real time. Its highly successful Starbucks loyalty program has over 12 million regular users. Some 27 percent of all transactions in U.S. stores are now made using mobile devices. The Starbucks app allows customers to order and pay for drinks and food ahead of time, so that they can bypass standing in line and just need to pick up their order.

Finally, as the U.S. market appears to be saturated with some 12,000 stores, Schultz believes that Starbucks has a great growth opportunity by opening more cafés overseas. Starbucks is planning to have more than 3,000 stores in China by 2019, up from 1,500 in 2015. Starbucks also plans to double its number of cafés elsewhere in Asia to more than 4,000 in the next few years.

As the creator of Starbucks, however, Schultz enjoyed a degree of freedom that an ordinary CEO would not have had. Howard Schultz is to Starbucks much like Steve Jobs was to Apple. Schultz has the reputation and power of personality to implement a change that reduces operational effectiveness in favor of delighting customers. Schultz was able to orchestrate a successful turnaround, and with it Starbucks was able to gain and sustain a competitive advantage. Exhibit MC8.2 shows that Starbucks outperformed the wider stock market by a huge margin.

In April 2017, Howard Schultz stepped down as Starbucks CEO, in a second attempt to retire.

EXHIBIT MC8.2 Starbucks (SBUX) Normalized (% Change) Stock Appreciation from Initial Public Offering (IPO) on June 26, 1992, to July 28, 2017. Comparison is Dow Jones Industrials.



SOURCE: Depiction of publicly available data.

Starbucks' new CEO is Kevin Johnson, who served as chief operating officer and second in command under Schultz. Schultz came out of retirement in 2008 when Starbucks was failing, and initiated a successful turnaround. His struggles are captured well in the title of his *New York Times* bestseller: *Onward: How Starbucks Fought for Its Life without Losing Its Soul*. After his return, Starbucks' market valuation appreciated some five-fold! Although Schultz clearly engineered a hugely successful turnaround of his beloved Starbucks, the question is whether the new CEO can sustain Starbucks' competitive advantage.

DISCUSSION QUESTIONS

1. How did Starbucks create its uniqueness in the first place? Why was this uniqueness so successful?
2. To be a source of competitive advantage over time, core competencies need to be continuously honed and upgraded. Why and how did Starbucks lose its uniqueness and struggle in the mid-2000s?
3. What strategic initiatives did Howard Schultz put in place to re-create Starbucks' uniqueness after his return in 2008? Detail each strategic initiative, and explain why each initiative was successful, if so.
4. What is your assessment of Howard Schultz as a strategic leader? Where on the Level-5 pyramid of strategic leadership would you place Schultz? Why? Explain.
5. How can new Starbucks CEO Kevin Johnson sustain the company's competitive advantage? What are some growth opportunities he could pursue? What recommendations would you give him?

Sources: Jargon, J. (2017, April 3), "New Starbucks CEO sees growth in suburbs, Midwest and lunch," *The Wall Street Journal*, Trefis Team (2017, Jan. 13), "Starbucks is ending its 'Evenings' beer and wine program," *Forbes*, January 13; Lublin, J.S., and J. Jargon (2016, Dec. 7), "At Starbucks, CEO transition plan includes vow not to hover," *The Wall Street Journal*, "Starbucks raises prices despite declining coffee costs," *The Wall Street Journal*, July 6, 2015; "Starbucks profit jumps, as revenue surges 18%," *The Wall Street Journal*, July 23, 2015; "Starbucks aims to double U.S. food sales," *The Wall Street Journal*, December 4, 2014; "Forty years young: A history of Starbucks," *The Telegraph*, May 11, 2011; Schultz, H. (2011), *Onward: How Starbucks Fought for Its Life without Losing Its Soul* (New York: Rodale Books); "At Starbucks, baristas told no more than two drinks," *The Wall Street Journal*, October 13, 2010; "Latest Starbucks buzzword: 'Lean' Japanese techniques," *The Wall Street Journal*, August 4, 2009; Behar, H. (2007), *It's Not About the Coffee: Leadership Principles from a Life at Starbucks* (New York: Portfolio); Clark, T. (2007), *Starbucked: A Double Tall Tale of Caffeine, Commerce, and Culture*. (New York: Little, Brown, 2007); Schultz, H., and D.J. Yang (1999), *Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time* (New York: Hyperion); "Five things Starbucks won't tell you," *The Wall Street Journal* video, <http://on.mktw.net/1UVStO6>; and <http://investor.starbucks.com>. See also "The Roastery experience: An unofficial guide to the Starbucks Roastery," <http://www.thestarbucksroastery.com/>, accessed August 3, 2017.

MiniCase 9

Business Model Innovation: How Dollar Shave Club Disrupted Gillette

WHILE MOST of our attention is captured by fancy high-tech innovations such as the iPhone or Tesla's sleek electric vehicles, innovations need neither to be high-tech nor radical to be successful. Until recently, Gillette, the company that invented the safety razor and the razor-razor-blade business model, dominated the \$3 billion U.S. market for wet shaving with some 75 percent market share. Yet Dollar Shave Club, which began as a fledgling startup with an initial budget of \$8,000, disrupted the powerful Gillette with a low-tech innovation and is gaining market share rapidly. How can the powerful Gillette, a unit of Procter & Gamble with annual revenues of \$65 billion, be beaten by a brash startup? Gillette's pattern of innovation over time led to overshooting in the market, resulting in a product that became overengineered and too expensive.

The entrepreneur King Gillette invented the safety razor some 115 years ago and also came up with the highly profitable business model of selling the razor for a low price and charging a premium for replacement razor blades. This razor-razor-blade business model, so named to commemorate its origins, has now been widely adopted. When introduced, the safety razor was a radical innovation, allowing Gillette a temporary competitive advantage. To sustain this advantage, Gillette followed up with incremental innovations, mainly by adding more blades to its razor until there were not one but six! As a result of this innovation pattern, Gillette's newest razor, the Fusion ProGlide with Flexball technology, a razor handle that features a swiveling ball hinge, costs \$11.49 (and \$12.59 for a battery-operated one) *per* razor!

This pricing exposed Gillette to low-cost disruption. The high-end, highly priced offering of the market leader is not only overshooting what the market demands, but also often priced too high. Does anyone



The entrepreneur Michael Dubin founded Dollar Shave Club using a business model innovation by providing an online subscription-based mail-order alternative to in-store retail purchases of razor blades. Many customers were not only turned off by Gillette's premium prices, but also by the inconveniences that in-store purchases entail. Given that packs of razor blades are a prime target for shoplifters, many stores lock them in glass vitrines, much to the dismay of customers who have to hunt down an employee with a key to access razor blades.

©Dan Krauss

really need six blades on one razor or want to pay over \$10 for one cartridge?

Seeing the opening provided by Gillette's focus on the high-end, high-margin portion of the market, Dollar Shave Club established a low-cost alternative to invade Gillette's market from the bottom up. With an \$8,000 budget and the help of a hilarious promotional video that went viral with 25 million views, entrepreneur Michael Dubin launched Dollar Shave Club, an e-commerce startup that delivers razors by mail. After the promotional video was uploaded on YouTube in March 2012, some 12,000 people signed up for Dollar Shave

Frank T. Rothaermel prepared this MiniCase from public sources. This MiniCase is developed for the purpose of class discussion. It is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: July 3, 2017.
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membership within the first 48 hours! The company also raised more than \$20 million in venture capital funding from prominent firms such as Kleiner Perkins Caufield & Byers and Andreessen Horowitz, among others. Dollar Shave Club followed up with advertising on regular television in addition to its online campaigns and has expanded its product lines with the introduction of additional personal grooming products.

Dollar Shave Club is an ecommerce company that uses a subscription-based business model. As the company's name suggests, its entry-level membership plan delivers a razor and five cartridges a month for just \$1 (plus \$2 shipping). The member selects an appropriate plan, pays a monthly fee, and receives razors every month in the mail. Dollar Shave Club is using a business model innovation to disrupt an existing market. Technology is defined as the methods and materials used to achieve a commercial objective. The technology or method here is the business model innovation, a potent competitive weapon. The entrepreneur identified the market need for those who don't like to go shopping for razors and certainly don't like to pay the high prices commanded by market leaders such as Gillette.

Procter & Gamble's competition also took notice. Unilever, P&G's European rival, has long stayed away from the U.S. wet shaving market because Gillette was so dominant. But noting how Dollar Shave Club disrupted the market, resulting in Gillette's rapid market share decline, Unilever saw its opening into the U.S. market. The Anglo-Dutch multinational consumer products company, with some \$61 billion in annual revenues and thus roughly the same size as P&G, offered a whopping \$1 billion in cash in 2016 to buy Dollar Shave Club. Not too bad of an offer for a five-year-old startup! Dubin happily accepted the offer and sold Dollar Shave Club to Unilever.

With sales of razors and razor blades moving rapidly online, Unilever is hoping to leverage this business model innovation to unseat Gillette's dominance in the U.S. market. Gillette is not sitting by idle: It responded swiftly by offering its own subscription-based service (Gillette Shave Club) and by lowering prices up to 20 percent, a move that was unimaginable in the past few decades. Successful innovations also lead to imitations.

A mere two years after Dollar Shave Club started, two entrepreneurs founded Harry's, another online, subscription-based mail-order business for shaving equipment. After Target invited Harry's to put flashy displays in all of its stores in 2016, its business took off. This was a smart move on Target's part, because it allowed it to put some competitive pressure on Gillette, which has historically held a near-monopoly position as a supplier with its 75 percent market share. Similar to Dollar Shave Club, Harry's business is growing rapidly. As a consequence of increased competition, Gillette's market share in the \$3 billion market for razors and razor blades has declined from some 75 percent (in 2010) to below 60 percent (by 2017), and continues to slide.

DISCUSSION QUESTIONS

1. If you buy shaving equipment, do you purchase it in a retail store or online? Explain your choice.
2. Apply the four I's framework: *idea*, *invention*, *innovation*, and *imitation* to describe the wet shaving industry in the United States over the past 100 years.
3. How was Gillette initially able to gain a competitive advantage? Was Gillette able to sustain its competitive advantage? If so, how?
4. What market opening did entrepreneurs, such as Michael Dubin with Dollar Shave Club, use to enter the industry? How did they enter the industry? What type of innovation did they use, and why were they successful?
5. Why did Unilever offer \$1 billion (in cash!) for Dollar Shave Club?
6. Do you think online startups such as Dollar Shave Club and Harry's will continue to steal market share from Gillette? Why or why not?

Sources: Terlap, S. (2017, Apr. 4), "Gillette, bleeding market share, cuts prices of razors," *The Wall Street Journal*, Terlap, S., and K. Safdar (2016, Nov. 9), "Online upstart Harry's razor jumps into Gillette's turf," *The Wall Street Journal*, Terlap, S. (2016, July 20), "Unilever buys Dollar Shave Club," *The Wall Street Journal*, Ng, S., and P. Ziobro (2015, June 23), "Razor sales move online, away from Gillette," *The Wall Street Journal*, Luna, T. (2014, Apr. 29), "The new Gillette Fusion Pro-Glide Flexball razor, to be available in stores June 9," *The Boston Globe*, Glazer, E. (2012, Apr. 12), "A David and Gillette story," *The Wall Street Journal*, and Dollar Shave Club promotional video, <https://www.youtube.com/dollarshaveclub>.

MiniCase 10

Competing on Business Models: Google vs. Microsoft

RIVALS OFTEN USE different business models to compete with one another. Because of competitive dynamics and industry convergence, Google (since 2015 a subsidiary of Alphabet) and Microsoft progressively move on to the other's turf. In many areas, Google and Microsoft are now direct competitors. This represents multipoint competition, as Google and Microsoft are rivals in many different markets. Both companies are about the same size in terms of revenues. In 2016, Microsoft had \$87 billion in revenues and Google \$89.5 billion.

In an attempt to manage its high degree of unrelated diversification more effectively, Google put in place a multidivisional structure overseen by Alphabet, a corporate holding company. Alphabet's 10 business units start with Google's core businesses (search, ads, apps, YouTube, Android, Chrome, and Google maps) in a single unit joined by Google X (artificial intelligence, high-altitude balloons providing global internet connectivity), Waymo (self-driving cars), Nest (smart homes), Access & Energy (broadband fiber services), Verily (life sciences, smart contact lenses), Calico (longevity research), Side Walk Labs (urban innovation), Google Ventures (venture capital investments in early phase startups), and Google Capital (venture capital investments in later-stage startups, similar to corporate venture capital investments). (See Exhibit MC10.1.) This sweeping restructuring allows the sprawling conglomerate to separate its highly profitable search and advertising business from its "moon shots," such as providing wireless internet connectivity via high-altitude balloons or developing contact lenses that double as a computer monitor and provide real-time information to the wearer.

Google continues to dominate the revenue streams for Alphabet—accounting for more than 99 percent of total revenues (see Exhibit MC10.2). Google is a standalone strategic business unit within Alphabet and has its own profit and loss responsibility. Google is run by CEO Sundar Pichai. Although Google started

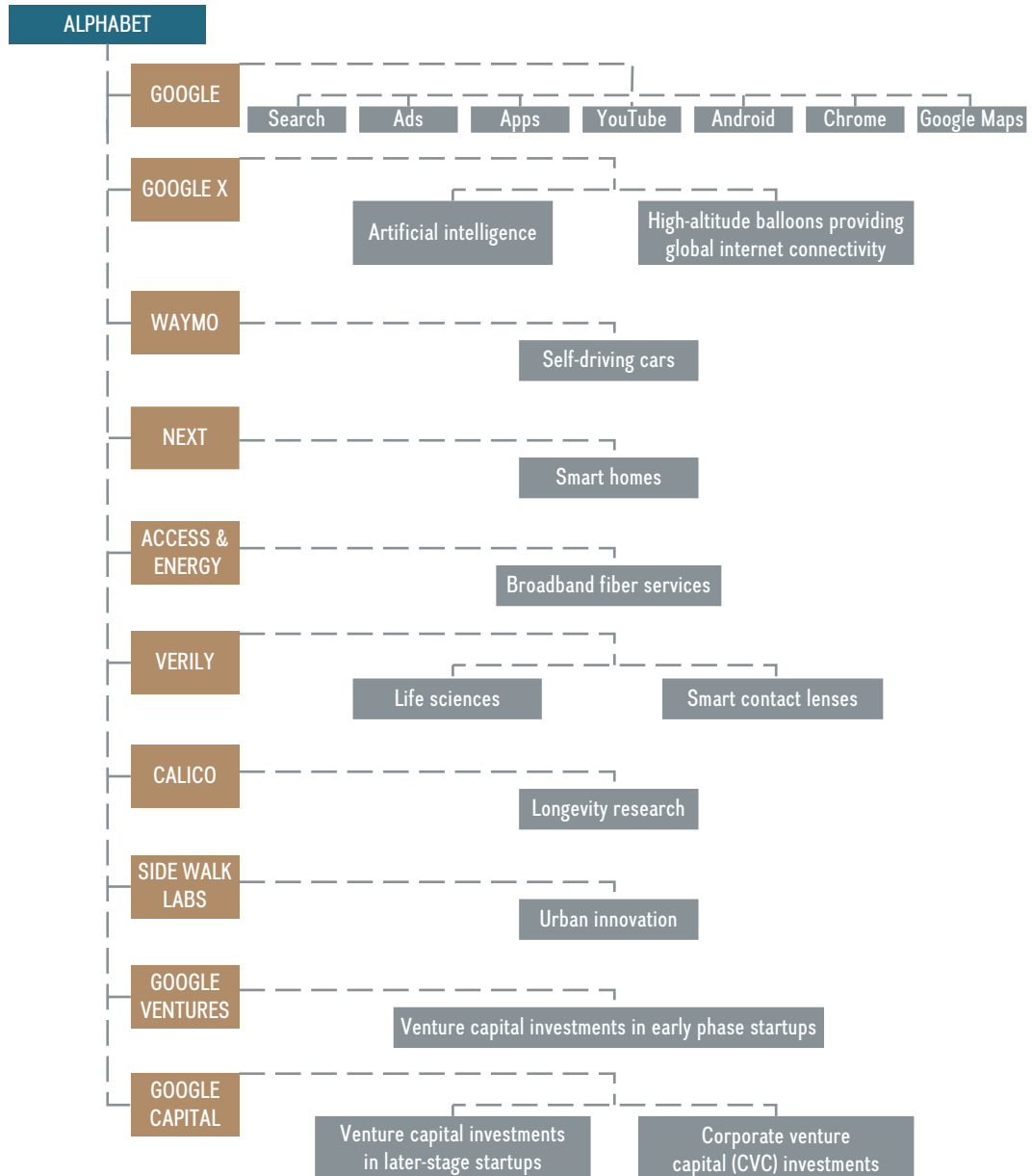


Sundar Pichai, Google CEO (top), and Satya Nadella, Microsoft CEO (bottom)
(top): ©AP Images/Tsering Topgyal; (bottom): ©Justin Sullivan/Getty Images

as an online search and advertising company, it now offers software applications (Google Docs, word processing, spreadsheet, e-mail, interactive calendar, and presentation software) hosted on the cloud (Google Drive), and also operating systems (Chrome OS for

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EXHIBIT MC10.1 / Alphabet's Multidivisional Structure (M-form) with Its Strategic Business Units, including Google's Businesses



the web and Android for mobile applications), among many other online products and services. In contrast, Microsoft began its life by offering an operating system (since 1985, called Windows), then moved into software applications with its Office Suite, and later into online search and advertising with Bing as well as

gaming with Xbox One. Both also compete in mobile devices (with Microsoft being focused more on the business market). Since 2014, Microsoft has been run by CEO Satya Nadella.

Given the companies' size combined with increasing multipoint competition, the stage is set for a clash

EXHIBIT MC10.2 /

Breakdown of Google's Revenues by Business Segment, (\$ millions) 2014–2016

Revenues	2014	2015	2016
Google Properties	\$45,085	\$52,357	\$63,785
Google Network Members Websites	14,539	15,033	15,598
Total Advertising Revenues	59,624	67,390	79,383
Total Google Revenues	65,674	74,544	89,463
Other Business Unit Revenues	327	445	809
Total Revenues	66,001	74,989	90,272

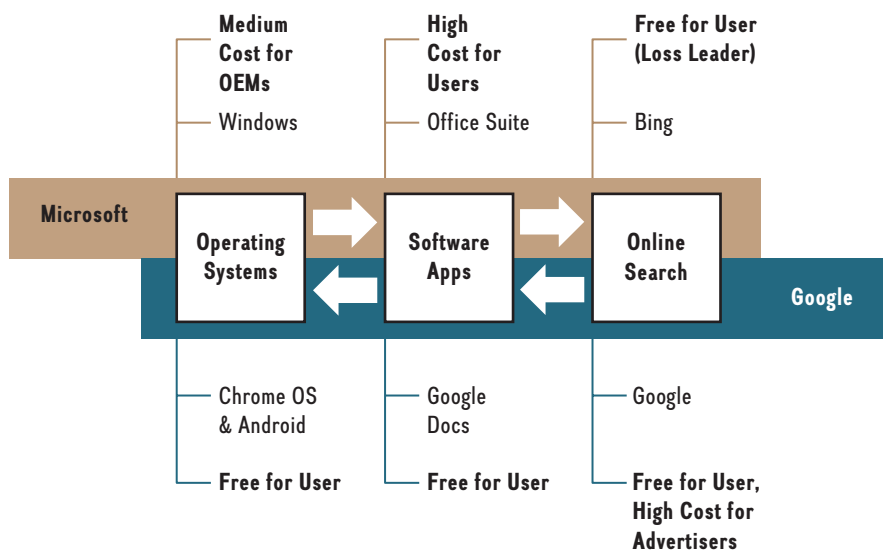
SOURCE: Tabulation of data from Alphabet annual reports (various years).

of the technology titans. In spring 2017, Alphabet was the second most valuable technology company globally, just behind Apple, but ahead of Microsoft, Amazon, and Facebook (in that order).

In competing with each other, Google and Microsoft pursue very different business models, as detailed in Exhibit MC10.3. Google offers its applications software Google Docs and hosting service Google Drive for free to entice and retain as many users as possible for its search engine. Google Drive follows a *freemium pricing model*, that is, a limited amount of data storage is free (15GB), while Google charges for additional storage space.

Although Google's flagship search engine is free for the end user, it makes money from sponsored links by advertisers. The advertisers pay for the placement of their ad on the results page, and they pay each time a user clicks through an ad (which Google calls a "sponsored link"). Many billions of these mini-transactions add up to a substantial business. Google uses part of the profits earned from its lucrative online advertising business to subsidize Google Docs and other service offerings (see Exhibit MC10.2 and Exhibit MC10.3). Giving away products and services to induce widespread use allows Google to benefit from *network effects*—the increase in the value of a product or service as more people use it. Google can charge advertisers for highly targeted and effective ads, allowing it to subsidize other product offerings that compete directly with Microsoft.

EXHIBIT MC10.3 / Competing Business Models: Google vs. Microsoft



SOURCE: Depiction of publicly available data.

Microsoft's business model, however, is almost the reverse of Google's (see the opposing arrows in Exhibit MC10.3). Initially, Microsoft focused on creating a large installed base of users for its PC operating system, Windows. It holds some 90 percent market share in operating system software for personal computers worldwide, although the PC has become less important as mobile devices have become more important in recent years. Yet, by 2017, the Windows and Office combination still generated about 40 percent of Microsoft's total revenues and 75 percent of its profits. Moreover, PC users are locked into a Microsoft operating system that generally comes preloaded with the computer they purchase; they then want to buy applications that run seamlessly with the operating system. The obvious choice for most users is Microsoft's Office Suite containing Word, Excel, PowerPoint, Outlook, and Access. Microsoft is working hard to transition the Office revenues from the old business model of standalone software licenses (\$150 for Office Home & Student) to repeat business via cloud-based subscriptions such as Office 365 Home & Student (which is \$70 per year). Exhibit MC10.4 details Microsoft's revenues by business segment.

Microsoft faces two immediate problems. The first is that people and businesses are buying fewer and fewer PCs (including both desktops and laptops) as personal and business computing move increasingly to

mobile devices. The second is the increasing use of cloud-based rather than standalone PC-based computing. The demand for Microsoft Office is driven by its installed base of Windows. The gross margin for the "classic" Office sitting on your computer is 90 percent, while that for the cloud-hosted Office 365 is only some 50 percent. To maximize the number of users that will upgrade from Windows 7 and the disappointing Windows 8 to Windows 10 launched in summer 2015, users of current versions of the operating system will get a free upgrade. (Microsoft did not offer a Windows 9 version.) On top of the aforementioned problems, Microsoft wrote off almost \$8 billion of its ill-fated \$9.4 billion acquisition of smartphone maker Nokia, along with cutting some 8,000 jobs.

As shown in Exhibit MC10.3, Microsoft uses the profits from its application software business to subsidize its search engine Bing, which—just like Google Docs—is a free product for the end user. Given Bing's relatively small market share, however, and the tremendous cost of developing the search engine, Microsoft, unlike Google, does not make any money from its online search offering; rather, it is a big money loser. The logic behind Bing is to provide a countervailing power to Google's dominant position in online search.¹ The logic behind Google Docs is to create a threat to Microsoft's dominant position in application software. The computing industry is undergoing a shift away from personal computers to mobile devices and cloud-based computing. Google holds more than 80 percent market share in mobile operating systems software with Android, while Microsoft's market share has shrunk to less than 1 percent.

Taken together, Google and Microsoft compete with one another for market share in several product categories through quite different business models. As shown in MC10.5, the stock market has valued Google's business model much more highly over the past decade (over 300 percent appreciation, compared to Microsoft's 130 percent appreciation). Also noteworthy is that Google has outperformed the tech-heavy NASDAQ-100 stock market index by a fairly wide margin, while Microsoft has underperformed it. Google was able to gain and sustain a competitive advantage over Microsoft.

Under CEO Satya Nadella, Microsoft is attempting to reinvent itself with a new "mobile first, cloud first" strategy. Microsoft is shifting quickly from being a Windows-only firm to a company offering diversified online services to its customers via the

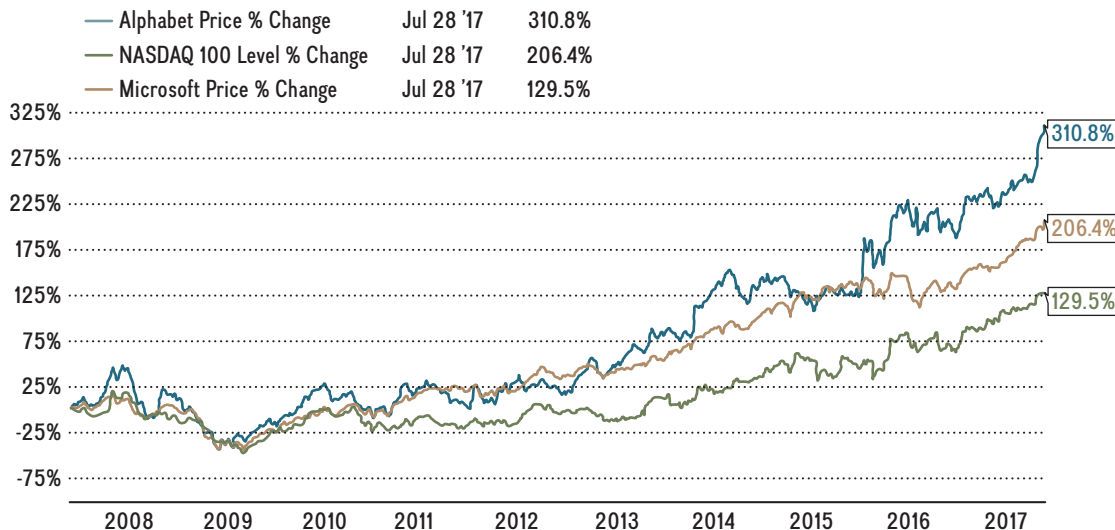
EXHIBIT MC10.4

Breakdown of Microsoft's Revenues by Business Segment, (\$ millions) 2014–2016

Revenues	2014	2015	2016
Productivity and Business Processes	\$26,976	\$26,430	\$26,487
Intelligent Cloud	21,735	23,715	25,042
More Personal Computing	38,460	43,160	40,460
Corporate and Other	(338)	275	(6,669)
Total Revenues	86,833	93,580	85,320

SOURCE: Tabulation of data from Microsoft annual reports (various years).

EXHIBIT MC10.5 / Stock Performance Comparison (normalized percentage change) of Alphabet, Microsoft, and NASDAQ-100 Index, 2007–2017



SOURCE: Depiction of publicly available data.

cloud, supported by its strong network of data centers. Nadella realizes that as more computing moves toward the cloud, Microsoft's tried-and-tested model of tightly integrating standalone software with hardware is no longer working. The absence of a sole focus on Windows in Microsoft's new mantra is evidence of where the new CEO sees the future of computing. Whether Nadella can engineer a turnaround at Microsoft, which is entering its fifth decade, remains to be seen.

DISCUSSION QUESTIONS

1. How is a strategy different from a business model? How is it similar?
2. Apply the why, what, who, and how of business models framework (as shown in Exhibit 5.10) to describe Google's and Microsoft's respective business models. What conclusions do you draw?
3. Why are Microsoft and Google becoming increasingly direct competitors?
4. Identify other examples of companies that were not competing in the past but are becoming competitors. Why are we seeing such a trend?

5. What recommendations would you give to Satya Nadella, CEO of Microsoft, to compete more effectively against Google?
6. What recommendations would you give to Sundar Pichai, CEO of Google, to compete more effectively against Microsoft?

Endnote

1. According to Microsoft lore, the name "Bing" actually is an acronym and stands for "Because It's Not Google."

Sources: "What Satya Nadella did at Microsoft," *The Economist*, March 16, 2017; Nicas, J. (2017, Jan. 26), "Google parent Alphabet finds new growth beyond search," *The Wall Street Journal*, "Microsoft at middle age: Opening windows," *The Economist*, April 4, 2015; Ovide, S. (2015, July 8), "Microsoft to cut 7,800 jobs on Nokia woes," *The Wall Street Journal*, Barr, A. (2015, July 13), "Google takes stricter approach to costs," *The Wall Street Journal*, Barr, A. (2015, July 17), "Google's share price hits all-time high," *The Wall Street Journal*, Gryta, T., and Y. Kim (2013, May 6), "The quest for a third mobile platform," *The Wall Street Journal*, Adner, R. (2012), *The Wide Lens. A New Strategy for Innovation* (New York: Portfolio); Levy, S. (2011), *In the Plex: How Google Thinks, Works, and Shapes Our Lives* (New York: Simon & Schuster); Anderson, C. (2009), *Free: The Future of a Radical Price* (New York: Hyperion); Gimeno, J. (1999), "Reciprocal threats in multimarket rivalry: Staking out 'spheres of influence' in the U.S. airline industry," *Strategic Management Journal* 20: 101–128; Gimeno, J., and C.Y. Woo (1999), "Multimarket competition, economies of scale, and firm performance," *Academy of Management Journal* 42: 239–259; Chen, M.J. (1996), "Competitor analysis and interfirm rivalry: Toward a theoretical integration," *Academy of Management Review* 21:100–134; and various Google and Microsoft annual reports.

MiniCase 11

Can Amazon Trim the Fat at Whole Foods?

WHEN FOUR YOUNG entrepreneurs opened a small natural-foods store in Austin, Texas, in 1980, they never imagined it would one day turn into an international supermarket chain with stores in the United States, Canada, and the United Kingdom. Some 35 years later, Whole Foods has about 450 stores, employs 85,000 people, and earned \$16 billion in revenue in 2016.

Whole Foods' mission is to offer the finest natural and organic foods available, maintain the highest quality standards in the grocery industry, and remain firmly committed to sustainable agriculture. The grocery chain differentiates itself from competitors by offering top-quality foods obtained through sustainable agriculture. This business strategy implies that Whole Foods focuses on increasing the perceived value created for customers, which allows it to charge a premium price. In addition to natural and organic foods, it also offers a wide variety of prepared foods and luxury food items, such as \$400 bottles of wine. The decision to sell high-ticket items incurs greater costs for the company because such products require more expensive in-store displays and more highly skilled workers, and many items are perishable and require high turnover. Moreover, sourcing natural and organic food is generally done locally, limiting any scale advantages. Taken together, these actions reduce efficiency and drive up costs. The rising cost structure erodes Whole Foods' margin.

Whole Foods Market: Stuck in the Middle

Given its unique strategic position as an upscale grocer offering natural, organic, and luxury food items, Whole Foods enjoyed a competitive advantage during the economic boom through early 2008. But as consumers became more budget-conscious in the wake of the deep recession in 2008–2009, the company's performance deteriorated. Competitive intensity also increased markedly because basically all supermarket



Amazon acquired Whole Foods Market in 2017 for close to \$14 billion. Many industry observers expect that Amazon will drastically reduce the organic grocer's notoriously high cost structure.

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chains and other retailers now offer organic food. As a result, sales performance of existing Whole Foods stores ("same-store sales," an important performance metric in the grocery business) has been declining since 2013. Overall, Whole Foods Market has sustained a competitive disadvantage, underperforming not only its competitors, but also the broader market by a wide margin. Over five years, Whole Foods Market underperformed the broader stock market by some 200 percentage points!

To revitalize Whole Foods, co-founder and CEO John Mackey decided to "trim fat" on two fronts: First, the supermarket chain refocused on its mission to offer wholesome and healthy food options. In Mackey's words, Whole Foods' offerings had included "a bunch of junk," including candy. Mackey is passionate about helping U.S. consumers overcome obesity

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to help reduce heart disease and diabetes. Given that, the new strategic intent at Whole Foods is to become the champion of healthy living not only by offering natural and organic food choices, but also by educating consumers with its new Healthy Eating initiative. Whole Foods Market now has “Take Action Centers” in every store to educate customers on many food-related topics such as genetic engineering, organic foods, pesticides, and sustainable agriculture.

Yet, a 2015 mislabeling scandal in New York—in which city officials found that Whole Foods had mislabeled weights of several freshly packaged foods such as chicken tenders and vegetable platters, leading to overcharges of up to \$15 an item—reinforced the public’s image of Whole Foods as overpriced. Mackey made a video apology and said this was an unfortunate but isolated incident caused by inadvertent errors of local employees. He also emphasized that the problems were found in only nine out of 425 stores (at that time).

Second, Whole Foods is trimming fat by reducing costs. To attract more customers who buy groceries for an entire family or group, it now offers volume discounts to compete with Costco, the most successful membership chain in the United States. Whole Foods also expanded its private-label product line, which now includes thousands of products at lower prices. The company also launched a new store format, “365 by Whole Foods Market,” based on its “365 Everyday Value” private label. The 365 stores focus exclusively on Whole Foods’ discount private labels, primarily to address the rise of discount competitor Trader Joe’s. The risk, however, is that this strategic initiative will cannibalize demand from the higher-end Whole Foods Markets, rather than taking away customers from Trader Joe’s. To offer its private-label line and volume-discount packages, Whole Foods is beginning to rely more on low-cost suppliers and is improving its logistics system to cover larger geographic areas more efficiently.

Mackey indicated that he planned to grow threefold in the future and believes the United States can profitably support some 1,200 Whole Foods stores. Larger scale and more efficient logistics and operations should allow the company to drive down its cost structure.

Whole Foods got stuck in the middle. It was outflanked on the low end by national grocery chains such as Publix or Kroger that offer a wide variety of organic foods at lower prices. At the higher end of

the market, Whole Foods Market was outperformed in urban centers by more specialized grocery stores focusing on specific segments such as seafood, meats, breads, cheese, or wines.

Amazon Acquires Whole Foods

Mackey’s turnaround initiative failed. This became more apparent as activist investors honed in on Whole Foods’ poor performance and highlighted the strategic shortcomings of the organic grocery chain. Even though Whole Foods Market attempted to strengthen its strategic position and also changed its board of directors, bringing in more large-chain retail experience, it was too little, too late. In 2017, Amazon acquired Whole Foods Market for close to \$14 billion.

With the acquisition of Whole Foods, Amazon continues its vertical integration along the value chain into physical retail spaces. Two aspects about this acquisition are particularly noteworthy. First, the Whole Foods acquisition is 10 times larger than any other acquisition the Seattle-based technology firm has undertaken (its second-largest acquisition, Twitch, a live-video streaming site was acquired for less than \$1 billion in 2014). Second, Amazon chose to make an acquisition in the grocery business and not in any other retail space. Why?

Amazon already dominates categories such as consumer electronics; therefore, it has no need to acquire a retail outlet such as Best Buy. The Whole Foods acquisition also offers Amazon a slew of new benefits: The organic grocery has a national footprint, which allows the ecommerce firm to test its latest technology on a much larger scale. For example, it has experimented with AmazonGo, a grocery concept without checkout counters. Shoppers fill their carts, and software automatically tallies the bill and deducts it from the person’s account. This technology could be rolled out at Whole Foods Market. Amazon will also be in a position to gather more data about shopping behavior. Grocery shopping is a particularly important need for consumers, and Amazon reasons if shoppers start associating groceries with Amazon, they will want to buy other items online also. In addition, Amazon is notoriously cost conscious. Bringing down the cost structure of Whole Foods by applying Amazon’s world-leading logistics technology could significantly strengthen the grocer’s strategic position.

Finally, Amazon bought Whole Foods to compete more effectively with Walmart. The largest physical retailer in the world is the largest U.S. grocery chain, accounting for some 15 percent market share. In addition, the grocery business is Walmart's most profitable, and is the strongest draw for customers to the big-box stores. In recent years, Walmart has been more aggressively moving to combat Amazon's dominance in ecommerce. The Bentonville, Arkansas, retail chain purchased Jet.com for more than \$3 billion in 2016, just one year after the site was launched. Jet.com offered lower prices than other retailers, expecting that many consumers would be willing to wait a bit longer for their shipments. The entrepreneurs were correct in making this assumption. In addition, Jet.com's strategic approach was tailor-made to enhance Walmart's online presence. Walmart.com has become a star performer as the site's user-friendliness has improved. Walmart has also been at the forefront of implementing a hybrid retail concept where consumers order goods online and pick them up in stores.

The stage is set for a battle of the retail giants, with the number-one old-line physical retailer in one corner of the ring and the ecommerce leader in the other. Stay tuned!

DISCUSSION QUESTIONS

1. Why was Whole Foods successful initially? Why did it lose its competitive advantage and underperformed its competitors?
2. Why did Whole Foods end up being "stuck in the middle"?
3. What changes do you expect at Whole Foods following the integration with Amazon?
4. Why did Amazon acquire Whole Foods? What are some operational and strategic reasons for this decision? Do you think the Whole Foods acquisition was a good move for Amazon? Why, or why not? Explain.

Sources: "Amazon's big, fresh deal with Whole Foods," *The Economist*, June 24, 2017; "An industry shudders as Amazon buys Whole Foods for \$13.7bn," *The Economist*, June 16, 2017; Stevens, L., and A. Gasparro (2017), "Amazon to buy Whole Foods for \$13.7 billion," *The Wall Street Journal*, June 16, 2017; "Whole Foods 365 takes on Trader Joe's," *Forbes*, June 22, 2015; "Whole Foods sales sour after price scandal," *The Wall Street Journal*, July 29, 2015; "Walter Robb: Whole Foods' other CEO on organic growth," *Fortune*, May 6, 2013; "Whole Foods profits by cutting 'whole paycheck' reputation," *Bloomberg Businessweek*, May 8, 2013; "Walter Robb on Whole Foods' recession lessons," *Bloomberg Businessweek*, August 9, 2012; "Frank talk from Whole Foods' John Mackey," *The Wall Street Journal*, August 4, 2009; "As sales slip, Whole Foods tries to push health," *The Wall Street Journal*, August 5, 2009; "The conscience of a capitalist," *The Wall Street Journal*, October 3, 2009; and www.wholefoodsmarket.com.

MiniCase 12

LEGO's Turnaround: Brick by Brick

IN THE DECADE between 2006 and 2016, LEGO—the famous Danish toy company—grew fivefold from a bit over \$1 billion in revenues to \$6 billion (see Exhibit MC12.1). In 2016 LEGO delivered its best results in terms of top-line revenues and bottom-line profits in its 85-year history. It beat out long-time rivals Mattel and Hasbro to become the world's largest and most profitable toy company. How did this privately held toy company from an obscure town in Denmark beat the well-funded and publicly traded U.S. companies Hasbro and Mattel?

Rediscovering, leveraging, and extending its core competency allowed a successful revival for a company that was floundering in the early 2000s. How did LEGO construct a successful turnaround? To answer this question, we first need to understand a bit of the history of this Danish wonder company.

LEGO's Humble Beginnings

The company was founded in 1932 by Ole Kirk Kristiansen. The name is a contraction of the Danish words *Leg godt*, which means “play well.” Only later did LEGO executives realize that *le go* in Latin also means “I assemble.” Throughout its history, LEGO has had numerous formidable competitors, but it has outperformed all of them. Tinkertoys were more complex; Lincoln Logs were limited in what could be constructed; traditional blocks had nothing to hold them together and were too large to show much detail. LEGO bricks were the right balance of simplicity, versatility, and durability.

LEGO competes for the attention of children and their parents, who buy the product. Plus, there is also a sizable group of adult LEGO fans. In the wake of the personal computer revolution in the 1990s, the popularity of LEGO began to wane because of attractive alternatives for children such as gaming consoles and computer games. By 1998, LEGO was in trouble. The Danish toymaker hired a highly touted turnaround expert to change its fortune. Unfortunately, he had



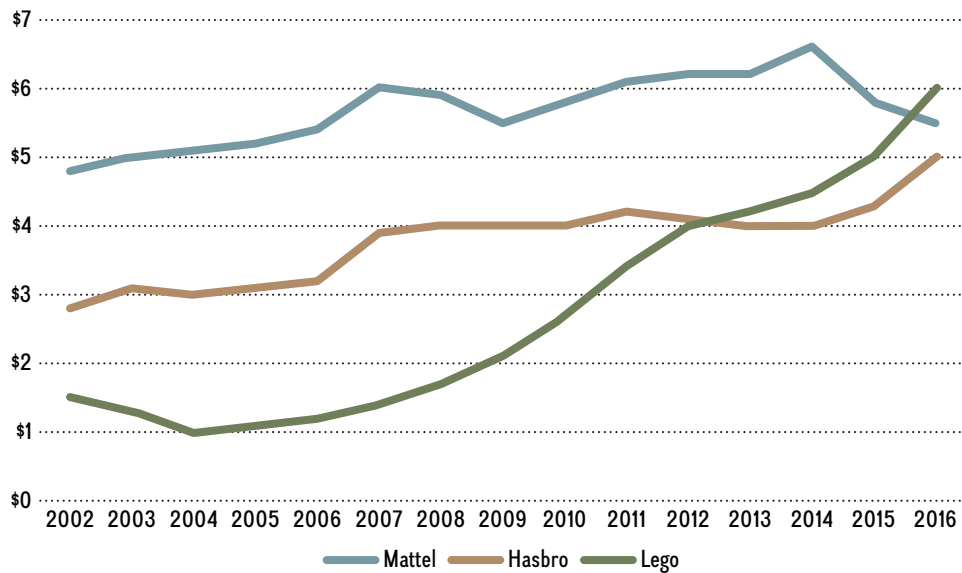
The LEGO Movie was a huge hit: The 3D computer-animated film had a budget of \$60 million, but grossed some \$500 million at the box office, making it one of the top five movies in 2014. Similarly, the 2017 *The LEGO Batman Movie* was almost as successful. With a budget of \$80 million, it grossed over \$310 million at the box office. ©Mim Friday/Alamy Stock Photo

no background in the toy industry. To make matters worse, the new executive decided that LEGO's hometown of Billund, Denmark, with 6,000 people, was too provincial. He continued to live in Paris and either commute or run the company remotely.

Things at LEGO went from bad to worse. It started hyperinnovating and diversified into too many areas, too quickly, and too far away from its core. Among a whole slew of other innovation failures, the company created a Saturday morning cartoon called “Galidor,” which flopped. During this time period, it also decided to become a lifestyle company and to offer LEGO-branded clothing and accessories.

LEGO'S TURNAROUND. By 2003, LEGO was on the verge of bankruptcy. To avoid this fate, the closely held private company, owned by the Kristiansen family

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EXHIBIT MC12.1 / Revenues of Mattel, Hasbro, and LEGO (in \$ billion), 2002–2016

SOURCE: Depiction of publicly available data.

since its inception, needed to do something drastic and quickly. Almost out of desperation, it hired Jørgen Vig Knudstorp as CEO. His résumé was quite unusual to say the least: He was only 35 years old (in comparison, the average age for a Fortune 500 CEO is 55 years), held a doctorate in economics, and was a former academic. Knudstorp had transitioned to McKinsey, one of the world's premier strategy consulting firms.

Knudstorp decreed that LEGO must “go back to the brick” and focus on core products. As a result of the strategic refocusing, LEGO divested a number of assets including its theme parks. It also drastically culled its product portfolio by almost 50 percent, from some 13,000 pieces to 7,000. At the same time as Knudstorp focused LEGO again on its fundamental strengths, he was also careful to balance *exploitation*—applying current knowledge to enhance firm performance in the short term—with *exploration*—searching for new knowledge that may enhance a firm's future performance. This allowed LEGO to improve the performance of traditional product lines, while at the same time to innovate, but this time in a much more disciplined manner.

In particular, LEGO increased sales of its well-known existing products by strengthening the interoperability of various LEGO pieces with other sets to

encourage user innovation and creativity. To drive innovation, LEGO has brought its adult fans into the product development process to leverage crowdsourcing—obtaining ideas from a large fan base using online forums and other internet-based technologies. To drive future growth, LEGO has been much more careful with its product extensions. In the past LEGO licensed its brand freely to other brands, including Star Wars, Indiana Jones, Harry Potter, the Lord of the Rings, Batman, the Simpsons, and Iron Man. But the benefits from these licensing agreements accrued mainly to the existing brands, because LEGO did not own the more critical intellectual property.

Knudstorp instead focused on owning and leveraging the core intellectual property. *The LEGO Movie* in 2014 was a particular high for the company, grossing \$500 million in the first year of its release on a \$60 million budget. Unlike in previous movie tie-ins, LEGO owned the intellectual property, which meant LEGO did not need to split profits with existing brands. In 2017, the company repeated this feat with *The LEGO Batman Movie*, also a computer-animated superhero comedy film that was almost as successful: With a budget of \$80 million, it grossed over \$310 million, making it one of the top-10 box office hits in 2017.

CHALLENGES. Although LEGO grew more than fivefold after Knudstorp took over, it faces a number of challenges. LEGO needs to strengthen its triple-bottom-line performance along economic, social, and ecological dimensions, and address globalization challenges.

LEGO must address ecological concerns in the face of growing consumer criticism: Its signature bricks are made from petroleum-based plastic. The company is searching for an environmentally friendly material to replace its bricks, which date to 1963. To reduce its relatively large carbon footprint, the company is spending millions on a 15-year R&D project in hope of finding an eco-friendly alternative. The goal is to invent and then manufacture bricks cost-effectively from a new bio-friendly material that will be virtually indistinguishable from the current blocks. It is a difficult problem to solve because LEGO bricks are precisely engineered to four-thousandths of a millimeter, hold a large range of colors well, and even make a sound when two pieces are snapped together.

To continue to grow, LEGO must become stronger in emerging growth markets such as China. LEGO is a comparatively new entry into China because of the fear that knockoff bricks have sufficiently damaged its brand. Knockoffs, which are rampant in China, are of inferior quality and even have injured some consumers. Yet, with growth in Western markets plateauing and a larger number of Chinese entering the middle class, this market opportunity is critical to LEGO's future success. Moreover, Chinese government officials endorse LEGO as a "mind toy," which helps children to develop creativity. The hope is that

creative children will grow up to drive innovation in firms, something many critics say Chinese companies lack. In addition, Chinese parents and grandparents are eager to spend money on things that are perceived to help their offspring to excel academically. In general, parents around the globe are more than happy to spend money on games that get their children away from mobile devices, computers, and game consoles.

To take advantage of the growth opportunity in China and other Asian countries such as India and Indonesia, LEGO opened offices in Shanghai and Singapore as well as a factory in Jiaxing, China. To address the globalization challenge more generally, LEGO also needs to internationalize its management. At this point, it is a local, small-town company that happened to be successful globally, especially in the West. LEGO hopes to become a global company that happens to have its headquarters in Billund, Denmark.

LEGO is also experiencing a change in leadership. After a widely successful turnaround, Jørgen Vig Knudstorp stepped down as CEO in 2017. His successor was Bali Padda, who had been LEGO's chief operating officer (COO), and thus second in command. The Indian-born British Padda was the first non-Danish CEO to run the company in its 85-year history. Just eight months into his tenure, Padda was replaced as LEGO CEO by Niels Christiansen, a Dane who comes from outside the toy industry. Christiansen headed the industrial group Danfoss and was hailed for moving it into the digital age. LEGO is hoping that he will do the same for the Danish toymaker.

DISCUSSION QUESTIONS

1. Why did LEGO face bankruptcy in the early 2000s? In your reasoning, focus on both external and internal factors.
2. What is LEGO's core competency? Explain.
3. Apply the core competence–market matrix to show how LEGO leveraged its core competence into existing and new markets over the past decade.
4. In terms of revenue growth, LEGO experienced a competitive advantage over both Hasbro and Mattel since 2007 because it grew much faster. What explains LEGO's competitive advantage?
5. What must LEGO do to sustain its competitive advantage in the future? One avenue to tackle this question is to think about diversification, both along products but also geography. Another



In 2017, Bali Padda was appointed CEO of LEGO, but served in that position for only eight months. Does this sudden change in leadership spell trouble for LEGO ahead?

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avenue is partnerships such as strategic alliances or even acquisitions. What lessons from LEGO's past should guide its future diversification?

Sources: Schmidt, G., and B. Barnes (2017, July 23), "For Warner Bros., a cinematic universe' built of Lego bricks," *The New York Times*, Bury, R. (2017,

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MiniCase 13

Cirque du Soleil: Searching for a New Blue Ocean

FOUNDED IN 1984 by two street performers, Guy Laliberté and Gilles Ste-Croix, in an inner-city area of Montreal, Canada, Cirque du Soleil today is the largest theatrical producer in the world. With its spectacularly sophisticated shows, Cirque's mission is to "evoke the imagination, invoke the senses, and provoke the emotions of people around the world."¹ Employing some 5,000 people (one-third of them artists) and with annual revenues of about \$1 billion, Cirque is hugely successful. Since its founding, some 200 million people worldwide have been dazzled by its high-quality artistic shows, with some 15 million viewers per year recently. How did Cirque become so successful while most circuses either shut down or barely survive?

Cirque's Blue Ocean Strategy and Value Innovation

Using a *blue ocean strategy* based on *value innovation*, Cirque du Soleil created a new and thus uncontested market space in the entertainment industry. A *blue ocean strategy* attempts to make the competition irrelevant by creating new, uncontested market spaces. For a blue ocean strategy to succeed, managers must resolve trade-offs between the two generic strategic positions—low cost and differentiation. This is done through value innovation, aligning innovation with total perceived consumer benefits, price, and cost. Instead of focusing to compete directly with rivals, attempting to outcompete them by offering better features or lower costs, successful value innovation makes competition more or less irrelevant by providing a leap in value creation, thereby opening new and uncontested market spaces.

Successful value innovation requires that a firm's strategic moves lower its costs and at the same time increase the perceived value for buyers. Lowering a firm's costs is primarily achieved by eliminating and reducing the taken-for-granted factors that the firm's



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rivals compete on. Perceived buyer value is increased by raising existing key success factors and by creating new elements that the industry has not offered previously. To initiate a strategic move that allows a firm to open new and uncontested market space through value innovation, managers must answer the four key questions below when formulating a blue ocean business strategy. In terms of achieving successful value innovation, note that the first two questions focus on lowering costs, while the other two questions focus on increasing perceived consumer benefits.

Value Innovation: Lower Costs

1. *Eliminate.* Which of the factors that the industry takes for granted should be eliminated?
2. *Reduce.* Which of the factors should be reduced well below the industry's standard?

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Value Innovation: Increase Perceived Consumer Benefits

3. *Raise.* Which of the factors should be raised well above the industry's standard?
4. *Create.* Which factors should be created that the industry has never offered?

Let's take a closer look at how Cirque used the *eliminate-reduce-raise-create* framework to reinvent the circus and to create a blue ocean of uncontested market space where competition is less of a concern.

ELIMINATE. In redefining the circus, Cirque du Soleil eliminated several taken-for-granted elements. First, Cirque did away with all animal shows. In recent years, the public has grown much more concerned about the humane treatment of animals. In addition, animals were the most expensive items for a circus because of their needed care, transportation, medical attention, insurance, and food consumption (a grown male lion can devour some 90 pounds of meat a day). Second, Cirque did away with star performers. They were also expensive; moreover, their name recognition in comparison to movie or sports stars is trivial. Third, it also abolished the standard three-ring venues. They were also expensive since so many performers had to be on stage at the same time, and they frequently created anxiety among circus-goers as they switched their attention rapidly from venue to venue. Finally, it did away with aisle concession sales. They annoyed most circus visitors not only because of the frequent interruptions and interference with the viewing experience, but also because visitors felt taken advantage of because of the vendors' high prices.

REDUCE. Cirque kept the clowns, but reduced their importance in the shows. Moreover, it shifted the clown humor from slapstick and low-brow to a more sophisticated and intellectually stimulating style.

RAISE. Cirque significantly raised the quality of the live performance with its signature acrobatic and aerial stunts to levels never seen before. While many other circuses did away with the luxurious circus tents of old in favor of generic low-cost venues that they rented, Cirque, in contrast, glamorized the circus tent. Using the tent as a unique venue capturing the magic of the circus, Cirque built tents with magnificent exteriors, which attracted the attention of the public, combined with a much higher level of comfort and amenities in the tent's interiors. Given that Cirque

attracted consumers who were used to paying much higher ticket prices for live performances at the theater and ballet than what the traveling circus charged, it raised ticket prices (starting at \$75 up to \$200). This was also possible because Cirque attracted an adult audience rather than several children coming with one adult to the circus.

CREATE. Cirque du Soleil created an entire new entertainment experience. Cirque did this by combining the fun and thrill elements of the traditional circus with the sophistication and high-quality choreographed performances of the theater. Cirque combined a number of unique entertainment features in novel ways. Each show follows a storyline characterized by intellectual, sophisticated, highly choreographed dance performances and artistic music. In this sense, Cirque shows are more akin to theater and ballet productions than traditional circuses, which deliver a lineup of unrelated acts. Akin to Broadway shows, Cirque offers multiple productions, playing at all the major venues across the world. In summary, Cirque has created much more sophisticated shows and dramatically increased demand, even at high ticket prices. With multiple productions and changing global venues, visitors now also go to the "circus" more frequently.

A Perfect Storm

Although Cirque du Soleil's venues are still glamorous, the company has fallen on hard times in recent years. A combination of external and internal factors led to a significant decline in performance. Cirque du Soleil was hit hard by the economic downturn during the 2008–2010 global financial crisis. Cirque's management made the situation worse through poor strategic decisions, including offering too many shows that were too little differentiated (at least in the mind of the consumer). As a consequence, Cirque lost its rarity appeal, and its payroll and costs also ballooned. Demand for its European shows dropped as much as 40 percent.

Misfortune also struck: In 2013 Cirque du Soleil experienced its first fatality as one of its performers fell 95 feet to her death during a live show in Las Vegas. The U.S. Occupational Safety and Health Administration (OSHA) has issued citations and fines; an in-depth investigation of safety practices at Cirque revealed a very high injury rate. Some Cirque performers claim that the pressure to perform at a high level created a culture where it is difficult to raise concerns

about acrobat safety. In 2016, the Cirque technician Olivier Rochette died during a San Francisco show after being hit in the head with an aerial lift. He was the son of Cirque founder, Gilles Ste-Croix.

As a consequence of external threats combined with internal weaknesses, Cirque du Soleil's revenues dropped from \$1 billion in 2012 to \$850 million in 2013. Cirque du Soleil is now in search of a new blue ocean. It is attempting to diversify away from its trademark live shows, characterized by creating theatrical spectacles combining high-suspense acrobat stunts. Given its poor safety record, it also revamped its shows to reduce the risk to its performers. Cirque-branded shows now deliver roughly 85 percent of the company's revenues; the company hopes to lower this to no more than 60 percent in five to 10 years as it continues to diversify into TV programs, special events, and auxiliary services such as ticketing. To increase its appeal to high-growth markets outside North America, it is infusing Russian and Chinese influences as well as improv comedy.

In 2015, Cirque du Soleil founder Guy Laliberté sold his controlling ownership stake to an investor group led by U.S. private-equity firm TPG. Other investors in Cirque include Fosun, a Chinese investment firm, and a Canadian pension fund. This deal valued Cirque at \$1.5 billion, down from a onetime \$3 billion valuation. Once flying high, Cirque du Soleil's valuation had dropped by 50 percent.

In searching for a new blue ocean, Cirque turned to acquisitions. In 2017, it bought Blue Man Productions, the New York performance art company. Cirque CEO Daniel Lamarre stated that with the acquisition of Blue Man Group, Cirque is able to develop new forms of entertainment, to reach new audiences, and to expand its repertoire of creative capabilities. The acquisition was part of broader strategy of diversification, the CEO indicated.

DISCUSSION QUESTIONS

1. Cirque du Soleil was able to gain and sustain a competitive advantage for many years. Why was Cirque du Soleil successful in the first place (while most other circuses barely survive)?
2. Which factors contributed to Cirque du Soleil losing its competitive advantage, and as a consequence led to a 50 percent drop in its valuation? Look at both external and internal factors.
3. A recent report by OSHA concludes that Cirque performers suffered a high number of injuries that required medical attention. One investigation found that Cirque's signature show had 56 injuries per 100 workers, which is four times the injury rate for professional sports teams, according to the Bureau of Labor Statistics. What can Cirque's management do to address the safety concerns of its performers? With more safety measures and less risky shows, do you think Cirque du Soleil will lose its differentiated appeal to audiences? Why or why not?
4. In the search for a new blue ocean, Cirque is now pursuing a strategy of diversification. What kind of diversification opportunities could Cirque pursue with its most recent acquisition of the Blue Man Group? Cirque's CEO evaluated the Blue Man Productions acquisition as follows: "It's a big, big shift, and it has been supported by the Blue Man Group. What it means is that now, we're no longer only a circus company, but now, we're going to become a global leader of entertainment. That's the goal we are pursuing."² Do you think Cirque can become a "global leader of entertainment." Hint: Fosun, one of Cirque's owners, is keen to see a stronger presence of Cirque in China.
5. Assume that Cirque du Soleil's new owner has retained you (or your study group) as consultants. First deduce Cirque's current strategy from its goals and actions. Then recommend changes in that strategy formation and implementation, with special attention to external threats and internal weaknesses. How can Cirque once again gain and sustain a competitive advantage? How can it best implement your suggested changes? Be specific.

Endnotes

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MiniCase 14

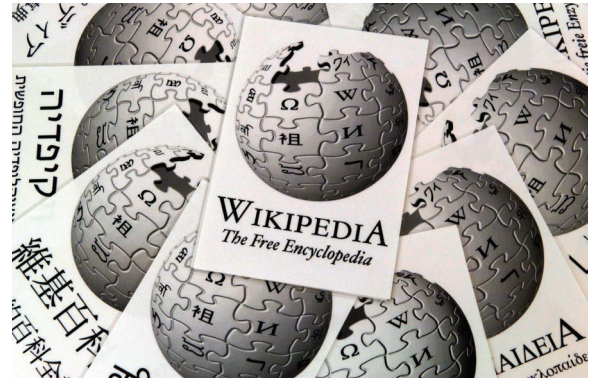
Wikipedia: Disrupting the Encyclopedia Business

WIKIPEDIA IS OFTEN the first source consulted for information about an unfamiliar topic, but this was not always the case. For almost 250 years, *Encyclopaedia Britannica* was the gold standard for authoritative reference works, delving into more than 65,000 topics with articles by some 4,000 scholarly contributors, including many by Nobel laureates. The beautiful leather-bound, multivolume set of books made a decorative item in many homes. In the early 1990s, when total sales for encyclopedias were over \$1.2 billion annually, *Encyclopaedia Britannica* was the undisputed market leader, holding more than 50 percent market share and earning some \$650 million in revenues. Not surprisingly, its superior differentiated appeal was highly correlated with cost, reflected in its steep sticker price of up to \$2,000.

Two innovation waves disrupted the encyclopedia business and over time drove Encyclopædia Britannica, Inc., the publisher of its namesake reference, to abandon its print version. Innovation—the successful introduction of a new product, process, or business model—is a powerful driver in the competitive process.

The first wave was initiated by the introduction of Encarta. Banking on the widespread diffusion of the personal computer, Microsoft launched its electronic encyclopedia Encarta in 1993 at a price of \$99. Although some viewed it as merely a CD version of the lower-cost and lower-quality Funk & Wagnalls encyclopedia sold in supermarkets, Encarta still took a big bite out of Britannica's market. Within only three years, the market for printed encyclopedias had shrunk by half, along with Britannica's revenues, while Microsoft sold over \$100 million worth of Encarta CDs. This level of disruption was compounded by a later development that overtook both Encarta and printed encyclopedias.

The second wave of disruption through innovation ultimately played the major role in driving the *Encyclopaedia Britannica* out of printed media. In January 2001, internet entrepreneur Jimmy Wales launched Wikipedia, the free online multi-language



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encyclopedia. In Hawaiian, *wiki* means quick, referring to the instant do-it-yourself editing capabilities of the site. Jimmy Wales identifies September 11, 2001, as a “Eureka moment” for Wikipedia. Before 9/11, Wikipedia was a small niche site. Immediately following the terrorist attacks, millions of people visited the site to learn more about what they had seen and heard on the news. Massive numbers of queries for search terms such as Al-Qaeda, the World Trade Center, the Pentagon, the different airlines and airports involved, etc., made Wales realize that Wikipedia “could be big.” Some 17 years later, Wikipedia is visited about 200 times a second, or 500 million times a month! It is ranked number five on the list of the world’s most visited websites, just behind Google, Facebook, YouTube (also owned by Google/Alphabet), and Baidu, but before well-known sites such as Yahoo, Amazon, Reddit, and others. Wikipedia has more than 40 million articles in nearly 300 languages, including some 5 million

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entries in English. Roughly 12,000 new pages spring up each day.

The combined effect of these two innovations devastated the business of printed encyclopedias. Sales of the beautiful leather-bound *Encyclopaedia Britannica* volumes declined from a peak of 120,000 sets in 1990 to a mere 12,000 sets in 2010. As a consequence, Encyclopaedia Britannica Inc. announced in 2012 that it no longer would print its namesake books. Its content is now accessible via a paid subscription through its website and apps for mobile devices. Encarta, which began the disruptive cycle and had developed its own online models to supplement delivery via CD, also fell. Microsoft ceased all Encarta versions in 2009.

The Power of Free, Open, and Easy

Wikipedia is a nonprofit, advertising-free, social entrepreneurship venture that owes its success to being free to all users, open to improvement by all, and easy to use, with no registration requirements and no advertisements to suffer through.

WHO PAYS FOR FREE? Wikipedia is exclusively financed by donations. The site runs regular calls for donations using slogans such as: “Please help us feed the servers,” “We make the Internet not suck. Help us out,” and “We are free, our bandwidth isn’t!”¹ Calls for donations also come in the form of personal appeals by co-founder Wales. These appeals are effective. In 2015, people donated more than \$50 million in 70 currencies, mostly via a large number of small donations through its website. When asked why Wales wouldn’t want to monetize one of the world’s most successful websites by placing targeted ads for example, Wales responded that running Wikipedia as a charity “just felt right, knowledge should be free for everyone.”² The question arises whether the donation model is sustainable given not only the increasing demand for Wikipedia’s services, but also the emergence of competitors.

OPEN SOURCE SUPPORTS QUALITY. Wikipedia’s slogan is *the free encyclopedia that anyone can edit*. Since it is open source, any person, expert or novice, can contribute content and edit pages using the handy “edit this page” button. Although Wikipedia has 70 million registered accounts, and any of these people can edit content, some 100,000 Wikipedians represent the core. They volunteer as editors and authors, representing a global community of widely diverse views.

The Upside How accurate is the result? What quality is the information? Although Wikipedia’s volume of English entries is more than 500 times greater than that of the *Britannica*, the site is not as error-prone as you might think. Wikipedia relies on the wisdom of the crowds, which assumes “the many” often know more than “the expert.” Moreover, user-generated content needs to be verifiable by made reliable sources such as links to reputable websites. A peer-reviewed study by *Nature* of selected science topics found that the error rates of Wikipedia and Britannica were roughly the same.

The Downside Wikipedia’s crowdsourcing approach to user-generated content is not without criticism. The most serious criticisms are that the content may be unreliable and not authoritative, that it could exhibit systematic bias, and that group dynamics might prevent objective and factual reporting. Therefore many users approach Wikipedia with caution; ideally, careful researchers go to and review the sources of Wikipedia articles for verification.

EASY. Despite real or perceived drawbacks, most users will verify that Wikipedia remains easy to use, especially free of the time-consuming apparatus found on sites that use a marketing-based business model.

What Next for Wikipedia?

Every year or so articles come out questioning the ability of Wikipedia to survive, given its uncertain funding and amorphous (and possibly shrinking) body of active volunteer editors.³ Others note that with expanding use, the demands on its servers and infrastructure threaten to bring the enterprise down.

In the meanwhile, social entrepreneur and founder Jimmy Wales keeps going. In 2017 he proposed a new and parallel effort, Wikitribune, aimed at fixing “broken” journalism.⁴ His goal? Evidence-based journalism following a model very similar to Wikipedia.

DISCUSSION QUESTIONS

1. The MiniCase provides an example of how advancements in technology can render traditional business models obsolete. With the introduction of its CD-based Encarta, Microsoft destroyed about half the value created by Britannica. In turn, Wikipedia moved away from Britannica’s

and Microsoft's proprietary business models to an open-source model powered by user-generated content and made available to anyone on the internet. In doing so, it destroyed Encarta's business, which Microsoft shut down in 2009. At the same time, Wikipedia created substantial benefits for users by shifting to the open-source model for content. Because Wikipedia was able to create value for consumers by driving the price for the end user to zero and making the information instantly accessible on the internet, there is no future for printed or CD-based encyclopedias.

- a. What are the general take-aways in regard to innovation as a driver of competition?
 - b. How can existing firms respond to disruptions in their industry?
2. The founder of Wikipedia, Jimmy Wales, is a social entrepreneur. Raised in Alabama, Wales was educated by his mother and grandmother who ran a nontraditional school. In 1994, he dropped out of a doctoral program in economics at Indiana University to take a job at a stock brokerage firm in Chicago. In the evenings he wrote computer code for fun and built a web browser. During the late 1990s internet boom, Wales was one of the first to grasp the power of an open-source method to provide knowledge on a very large scale. What differentiates Wales from other web entrepreneurs is his idealism: Wikipedia is free for the end user and supports itself solely by donations. Wales' idealism is a form of social entrepreneurship: His vision is to make the entire repository of human knowledge available to anyone, anywhere for free.
- a. If you were the founder of Wikipedia, would you want to monetize the business? Why or why not?
 - b. What are the pros and cons of for-profit versus nonprofit business? Where do you come down?

3. How can Wikipedia maintain and grow its ability to harness the crowdsourcing of its "Wikipedians" to maintain high-quality and quickly updatable content?
4. As Wikipedia keeps growing, do you think it can continue to rely exclusively on time and money donations? Why or why not? What other business models could be considered? Would any of those "violate the spirit of Wikipedia"? Why or why not?
5. What, if anything, should Wikipedia do to ensure that its articles present a "neutral point of view"? Shouldn't the crowdsourcing approach ensure objectivity? Does a "neutral point of view" matter to Wikipedia's sustainability? Why or why not?
6. Qualify Wales' efforts around Wikitribune as to the degree to which it has the same disruptive and innovative benefits as Wikipedia.

Endnotes

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3. See, for example, Simonite, T. (2013, Oct. 22), "The Decline of Wikipedia," *MIT Technology Review*.
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MiniCase 15

Disney: Building Billion-Dollar Franchises

WITH \$55 BILLION in annual revenues in 2017, Disney is the world's largest media company and is renowned for its Walt Disney Studios and the popular Walt Disney Parks and Resorts. Over the past decade, Disney has grown through a number of high-profile acquisitions, including Pixar (2006), Marvel (2009), and Lucasfilm (2012), the creator of *Star Wars*. All this was done with the goal of building billion-dollar franchises based on movie sequels, park rides, and merchandise. In 2017, Disney revealed even bigger ambitions.

Disney's Corporate Strategy

As a diversified media company, Disney is active in a wide array of business activities—movies, amusement parks, cable and broadcast television networks (ABC, ESPN, and others), cruises, and retailing. It became the world's leading media company to a large extent by pursuing a corporate strategy of *related-linked diversification*. That is, some, but not all, of Disney's business activities share common resources, capabilities, and competencies.

Disney executes its corporate strategy by entering alliances and acquiring other media businesses to create theme-based franchises. The corporate strategy of creating billion-dollar franchises through diversification is Disney's main focus. CEO Bob Iger leads a group of about 20 executives whose sole responsibility is to hunt for new billion-dollar franchises. This group of senior leaders decides top-down which projects are a go and which are not. They also allocate resources to particular projects. Disney has even organized its employees in the consumer products group around franchises such as *Frozen*, *Toy Story*, *Star Wars*, and other cash cows.

The corporate strategy around building billion-dollar franchises is certainly paying off: Disney has seen a steady growth to its top line, and it earned some \$10 billion in profits in 2016. Its stock rose more than 350 percent between 2010 and 2017, outperforming rivals such



Star Wars: The Force Awakens is part of the global *Star Wars* franchise. This sequel alone is estimated to turn into a \$10 billion franchise for Disney.
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as Time Warner, Sony's Columbia Pictures, and 21st Century Fox.

Disney and Pixar: "Try Before You Buy"

To understand Disney's corporate strategy of growing through acquisition, let's look at one of the most successful deals in recent history: Disney acquired Pixar, and then built a number of billion-dollar franchises around it. It all started with a strategic alliance. Pixar started as a computer hardware company producing high-end graphic display systems. One of its customers was Disney. To demonstrate the graphic display systems' capabilities, Pixar produced short, computer-animated movies. Despite being sophisticated, Pixar's computer hardware was not selling well, and the new venture was hemorrhaging money. To the rescue rode

Frank T. Rothaermel prepared this MiniCase for the purpose of class discussion. He gratefully acknowledges research assistance by Amey Sahasrabudde. This MiniCase is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: August 1, 2017. © Frank T. Rothaermel.

not Buzz Lightyear, but Steve Jobs. Shortly after being ousted from Apple in 1986, Jobs bought the struggling hardware company for \$5 million and founded Pixar Animation Studios, investing another \$5 million into it. The Pixar team, led by Edwin Catmull and John Lasseter, then transformed the company into a computer-animation film studio.

To finance and distribute its newly created computer-animated movies, Pixar entered a strategic alliance with Disney. Disney's distribution network and its stellar reputation in animated movies were critical complementary assets that Pixar needed to commercialize its new type of films. In turn, Disney was able to rejuvenate its floundering product lineup, retaining the rights to the newly created Pixar characters and to any sequels.

Pixar became successful beyond imagination as it rolled out one blockbuster after another: *Toy Story* (1, 2, and 3), *A Bug's Life*, *Monsters Inc.*, *Finding Nemo*, *The Incredibles*, and *Cars*, grossing several billion dollars. Given Pixar's huge success and Disney's abysmal performance with its own releases during this time, the bargaining power in the alliance shifted dramatically. Renegotiations of the Pixar–Disney alliance broke down in 2004, reportedly because of personality conflicts between Steve Jobs and then-Disney Chairman and CEO Michael Eisner.

After Robert Iger was appointed CEO, Disney acquired Pixar for \$7.4 billion in 2006. The success of the alliance demonstrated that the two entities' complementary assets matched, and it gave Disney an inside perspective on the value of Pixar's core competencies in the creation of computer-animated features. Integrating Pixar allowed Disney to transfer and apply some of its unique competencies including marketing, brand building, product extensions.

Acquisitions Ever After . . .

In 2009, Disney turned to acquisitions again. The acquisition of Marvel Entertainment for \$4 billion added Spider-Man, Iron Man, The Incredible Hulk, and Captain America to its lineup of characters. Marvel's superheroes grossed a cumulative \$15 billion at the box office, with *The Avengers* bringing in some \$2 billion. In 2012, Mickey Mouse's extended family was joined by Darth Vader, Obi-Wan Kenobi, Princess Leia, and Luke Skywalker when Disney acquired Lucasfilm for more than \$4 billion.

In 2014, Disney acquired Maker Studios, a YouTube-based multichannel network, for \$675 million. Under Disney, Maker Studios is no longer focused on

providing some 60,000 YouTube creators with support by promoting their channels and selling ads. Rather, Maker now the marching orders to focus on no more than the top 250 YouTube content creators with large followings. The goal is to build billion-dollar franchises in the new on-demand TV space. One Maker Studios early success story was YouTube megastar PewDiePie, who at one point had the most successful YouTube channel and for many years was one of the highest-profile stars on YouTube. In 2017, however, Disney cut ties with PewDiePie following his posting of videos in which he made inflammatory remarks, not in line with Disney's values.

Building Billion-Dollar Franchises

After taking the reins, CEO Iger transformed a lackluster Disney following a decade or so of inferior performance by refocusing it around what he calls *franchises*, which generally begin with a big movie hit and are followed up with derivative TV shows, theme park rides, video games, toys, clothing such as T-shirts and PJs, among many other spin-offs. Rather than churning out some 30 movies per year as it did before Iger, Disney now produces about 10 movies per year, focusing on creating box-office hits. Disney's annual movie lineup is dominated by such franchises as *Stars Wars* and Marvel superhero movies and also by live-action versions of animated classics such as *Cinderella* and *Beauty and the Beast*. The biggest Disney franchises that started with a movie hit include the *Pirates of the Caribbean* (with the franchise grossing more than \$4 billion), *Toy Story* (over \$2 billion), *Monsters Inc.* (close to \$2 billion), *Cars* (over \$1 billion), and, of course, *Frozen*.

The 2013 animated movie *Frozen* (made by Walt Disney Animation Studios run by Pixar execs Catmull and Lasseter) has grossed over \$1.5 billion, making it the most successful animated movie ever. To further build its *Frozen* franchise, Disney is working on a sequel of its animated movie hit for release in late 2019, and in the meanwhile it has spun off several shorter films, much merchandise, and a dreamlike ride through the fictional world of Arendelle at Disney World's Epcot Center, replacing a previous attraction that had grown stale.

The *Star Wars* franchise, however, is clearly the crown jewel in Disney's lineup of billion-dollar franchises. The 2015 *Star Wars* sequel *The Force Awakens* grossed over \$2 billion on the big screen, making it the third-best-selling movie ever after *Avatar* and *Titanic*.

Intergalactic Finance: The Star Wars Franchise Is Worth \$10 Billion

The numbers generated around the Star Wars franchise do seem fantastic. First, just consider the grosses of the movies. Although *The Force Awakens* grossed over \$2 billion in box-office receipts on a budget of about \$260 million, NYU finance professor Aswath Damodaran estimates the final gross receipts of the 2015 *Star Wars* sequel to be \$10 billion.

HOW ONE MOVIE GROSSES \$10 BILLION. Professor Damodaran extrapolated add-on revenue by using historical data, so he could project anticipated revenues not just from *The Force Awakens* but also from other announced sequels in the pipeline. Here is how a simple version of his model plays out, based on the reported box-office receipts the 2015 for sequel of roughly \$10 million. Note that add-on revenue is computed using a multiplier (shown in parentheses) of box-office receipts.¹

- Box-office receipts: \$2 billion.
- Streaming revenue (1.2): \$2.4 billion.
- Toys and merchandise (1.8): \$ 3.6 billion
- Books and e-books (0.2): \$ 0.4 billion.
- Gaming (0.5): \$ 1 billion.
- TV shows and other (0.5): \$ 1 billion.

Thus the total gross receipts for *The Force Awakens* are \$10.4 billion.

VALUATION OF A FRANCHISE. By coincidence, Damodaran ultimately values the entire Star Wars franchise at the same amount—around \$10 billion. He therefore concludes that Disney's \$4 billion price tag for Lucasfilm was a good investment. Again, the astonishing valuation of the franchise—or the reveal of the likely true gross receipts of a new film in the franchise—is explained by Disney's ability to build revenue on top of billion-dollar franchises through product extensions and add-ons. The Star Wars empire has a far reach in many corners of commerce, let alone in the galaxy.

Clouds on Disney's Horizon

While things have been sunny in Southern California, where Disney is headquartered, there are clouds on the horizon, which is to say Disney has been facing a number of potential challenges.

1. **Risks of Relying on a Few Big Franchises.** Disney's approach is risky. What if the pipeline dries up? That is, how sustainable is an acquisition-led growth strategy? Not many media companies remain of the same caliber as Pixar, Marvel, or Lucasfilm.
2. **Losing Originality.** Critics worry that focusing on billion-dollar franchises hampers Disney's originality. Moviegoers could write off Disney's offerings as too predictable.
3. **Problems on the TV Side.** Roughly half of Disney's profits come from its TV networks ESPN, ABC, and others. Yet that industry is in disruption. People spend more time and sometimes money watching content online via YouTube, Netflix, Hulu, and other streaming services, and they watch less TV. This means the numbers of TV viewers and cable subscribers are in decline.
4. **Underperforming Acquisitions.** Disney's acquisitions have not been uniformly successful. While Disney won big with franchise-based studios Pixar and Lucasfilm, it has also lost money and focus with the acquisition of technology companies. Examples include online video producer Maker Studios (2014) and social gaming company Playdom Inc. (2010).
5. **Issues of Succession.** Who will succeed Robert Iger as CEO? He was the architect of Disney's corporate strategy of building billion-dollar franchises and implemented it to achieve new levels of growth. Appointed in 2005, he originally planned to step down in 2015. Most recently he extended his tenure until 2019. With no clear internal candidates to take over the mantle as CEO, Disney has no heir apparent.

These challenges were suddenly cast in a new light when Iger announced a strategic shift, significantly changing the complexity of several of these challenges.

Iger Joins the Disruption

In 2017 Iger announced that Disney would launch two streaming services similar to Netflix. One service would focus on ESPN's audience and start in 2018, the other on Disney's huge catalog of original content and start in 2019.

AN ESPN STREAMING SERVICE. While the ESPN service will focus on ESPN's audience, it will not cannibalize the existing ESPN stations. The ESPN

streaming service will carry new sports content that extends the ESPN cable content—if you already subscribe to ESPN on cable, you would be able to also watch the cable events over the streaming service.

This decision may reflect the importance that cable companies place on the ESPN sports channels as their single biggest draw overall, their “must-have” component of the cable offering. But the cable companies were increasingly frustrated by rising costs, especially as the costs affected viewership. ESPN, often the most expensive part of the cable bundle, accounts for over \$8 per month of cable charges *even when distributed across all subscribers*, by some estimates.

Cable companies wanted Disney to rein in fees because subscribers were growing more restive and some had already jumped ship. ESPN at its peak had 100 million subscribers, but has lost close to 12 million subscribers in the past five years. And cable companies feared such a loss was just the beginning of a subscriber revolt, with subscribers demanding ESPN become unbundled from cable packages.

A FRANCHISE STREAMING SERVICE. While the proposed ESPN streaming service may not adversely impact ESPN channels, the decision to create a streaming service for many of Disney’s blue-chip franchises has much greater potential, with special impact on Netflix.

Iger has announced that Disney will be pulling most of its movies from Netflix over the next two years. Some analysts see this move as reducing the value of Netflix to subscribers. Others see the content being pulled as relatively minor. First, Disney has not yet decided if it would pull its Marvel or Star Wars movies from Netflix, and second, none of the Marvel series (think the Marvel Defenders, Jessica Jones, and Luke Cage) will go because they are coproductions with Netflix.

TECHNOLOGY IS KEY. To make this streaming happen, Disney is making one highly focused technology acquisition. Last year it acquired a third of BamTech—which supplies streaming services for HBO and many sports events—and has an option to buy a controlling interest.

EARLY DAYS. It is too early yet to tell how this shift in corporate strategy will play out. But what is clear now is that in the face of various issues noted above, Disney under Iger has decided to increase its independence in unsettled media markets. Instead of fighting the disruption, Disney is joining it.

DISCUSSION QUESTIONS

1. Before announcing its streaming services, what type of corporate strategy was Disney pursuing? Which core competencies were shared and how?
2. Why do you think Disney’s acquisitions of Pixar, Marvel, and Lucasfilm were so successful, while other media interactions such as Sony’s acquisition of Columbia Pictures and News Corp.’s acquisition of Myspace were much less successful?
3. Do you think focusing on billion-dollar franchises has been a good corporate strategy for Disney? What are pros and cons of this strategy?
4. Given the build-borrow-or-buy framework, do you think Disney should pursue alternatives to acquisitions? Why or why not?
5. Given Disney’s focus on creating and monetizing billion-dollar franchises, some industry observers now view Disney more as a global consumer products company like Nike rather than a media company. Do you agree with this perspective? Why or why not? What strategic implications would it have if Disney is truly a global consumer products company rather than a media and marketing company?
6. What type of corporate strategy is evidenced in Disney’s announced streaming services? What are the potential benefits and risks of such strategies?

Endnote

1. This assessment uses the simple and generic model taken from Aswath Damodaran’s 2015 blog posting that generated the 2016 *Forbes* article. Specifically this computation uses the multipliers to apply to box-office receipts of movies in the pipeline. Compare: Damodaran, A. (2015), “Intergalactic finance: Valuating the Star Wars franchise,” *Musings on Markets* [blog], December 28, at <http://aswathdamodaran.blogspot.com/2015/12/intergalactic-finance-valuating-star-wars.html>, and Damodaran, A. (2016), “Intergalactic finance: Why the Star Wars franchise is worth nearly \$10 billion to Disney,” *Forbes*, January 6.

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MiniCase 16

Hollywood Goes Global

BLOCKBUSTER MOVIES have always been a quintessentially American product. Globalization, however, has changed the economics of the movie industry. Foreign ticket sales for Hollywood blockbusters made up 50 percent of worldwide totals in 2000. By 2016, they made up more than 70 percent, with some movies (e.g., *Transformers: Age of Extinction*) grossing 80 percent of total box-office receipts overseas. Of the total \$38.6 billion that Hollywood movies grossed in 2016, more than \$27.2 billion came from outside North America. Today, largely because of the collapse of DVD/Blu-ray sales, Hollywood would be unable to continue producing big-budget movies without foreign revenues. Foreign sales now make or break the success of newly released big-budget movies.

Avatar is the highest-grossing movie to date, earning almost \$3 billion since its release in 2009. Non-U.S. box-office sales account for close to 75 percent of that number. *Avatar* was hugely popular in Asia, especially in China, where the government gave permission to increase the number of movie theaters showing the film from 5,000 to 35,000. Another of James Cameron's popular films, *Titanic*, grossed almost 70 percent of its close to \$2 billion earnings in overseas markets. Exhibit MC16.1 depicts the lifetime revenues of Hollywood's all-time blockbuster movies, broken down into domestic and foreign.

“We Need Movies That Break Out Internationally”

Given the increasing importance of non-U.S. box-office sales, Hollywood studios are changing their business models. Rob Moore, vice chairman of Paramount Pictures, explains: “We need to make movies that have the ability to break out internationally. That’s the only way to make the economic puzzle of film production work today.”¹ For instance, in 2014, only one film grossed more than \$300 million in the U.S. home market (*Guardians of the Galaxy*).



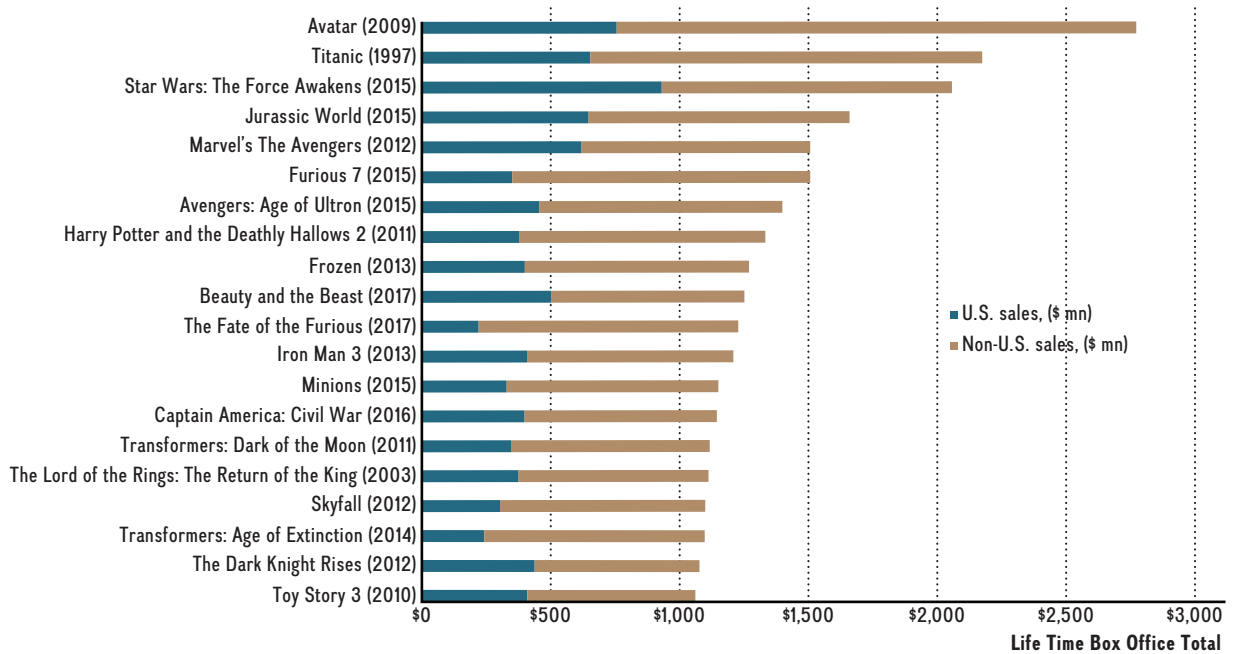
With a budget of \$150 million, and starring Matt Damon and Jing Tian, *The Great Wall* is the most ambitious coproduced movie between Hollywood and Chinese film studios to date. *The Great Wall* is also the most expensive movie ever shot exclusively in China.

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PICTUR/Album/Newscom

Thanks to international releases, however, 2014 was one of the most profitable for Hollywood. As a result, movie studios have changed a number of tactics. Some mega-releases such as Disney's *Monsters University* (the prequel to *Monsters, Inc.*) premiered first in foreign markets before being shown in the United States. *Avengers: Age of Ultron* set the record in 2015 for the biggest overseas opening, surpassing a record set weeks earlier by *Furious 7*, in *The Fast and the*

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EXHIBIT MC16.1 / Lifetime Revenues of Top 20 Hollywood Blockbuster Movies (release year in parentheses)



SOURCE: Depiction of data from Box Office Mojo, <http://boxofficemojo.com> for years 2010–2017.

Furious film series. Unsurprisingly, the record passed back to the eighth movie in *The Fast and the Furious* film series when it hauled in \$44.3 million in the opening weekend, with a whopping 80 percent of its total opening weekend sales coming from screens outside the United States.

Hollywood is also adapting scripts to appeal to global audiences, casting foreign actors in leading roles, and pulling the plug on projects that seem too U.S.-centric. For example, the film *G.I. Joe: The Rise of Cobra* prominently featured South Korean movie star Byung-hun Lee and South African actor Arnold Vosloo. Although Hollywood has had to release versions of films edited to meet local censorship rules for many years, a recent phenomenon has been the recording of special scenes to cater to audiences in specific markets. Other challenges also loom. In 2014, hackers famously penetrated Sony Pictures and publicly posted damaging internal e-mails as retaliation for the comedy film *The Interview*, about the assassination of North Korean leader Kim Jong-un.

The fact that Hollywood now garners roughly seven out of 10 dollars of its revenues internationally is somewhat surprising, given several constraints

faced by U.S. films when selling internationally. Besides potential government interference with content, there are numerous piracy concerns. Even in the European Union (EU), where some countries impose fines on producers and buyers of pirated content, other countries, such as Spain, have long been havens for the distribution of illegal movies and music. In 2011, Spain passed a law to provide better protection of copyrighted material, but enforcement is notoriously difficult in a country where nearly 50 percent of all internet users admit to illegally downloading copyrighted content (twice the EU average).

Movie studios are moving to simultaneous worldwide releases of expected blockbusters in part to try to cut down on the revenues lost to piracy. Yet growth in China (and elsewhere) is not as profitable as traditional releases in the United States. For example, film distributors typically earn 50 to 55 percent of box-office revenues in America. The average in many other countries is closer to 40 percent (the rest goes to the cinema owner). But in China, a typical Hollywood film distributor gets only 15 percent of the box-office ticket revenue. Moreover, stringent regulations by the Chinese government mean that only a select few

Hollywood movies can make it to Chinese theaters. As of 2017, China allows only 34 foreign movie imports a year. The state-backed distributor China Film Group also restricts most Chinese theaters to Chinese films during national holidays, further reducing revenue for Hollywood studios.

China: The Largest Movie Market by 2020

That the economics of the movie industry have fundamentally changed is further demonstrated by the fact that in 2016 China was the second-largest contributor to Hollywood's top line, with close to \$7 billion in annual revenues. China's overall box-office revenues have tripled between 2013 and 2016. Most impressive, China is poised to exceed the United States in terms of total box-office sales in a few short years, making it the largest movie market globally. Exhibit MC16.2 depicts overall box-office revenues for the United States and China.

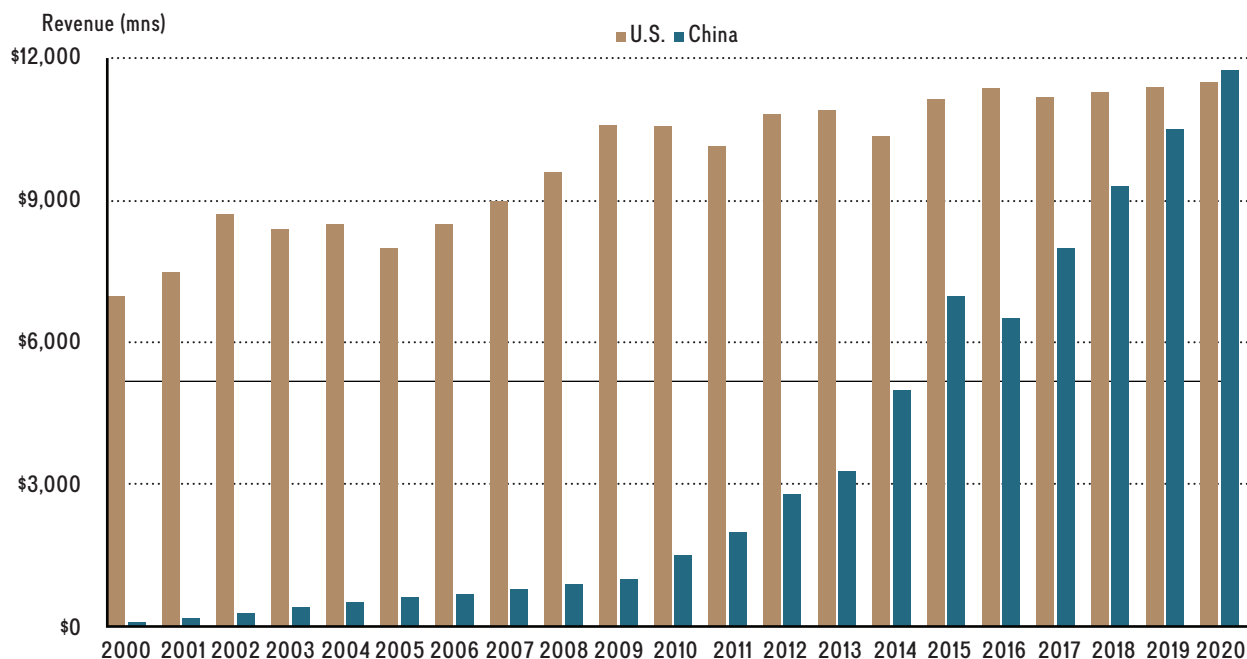
Given China's importance as a movie market, it is no wonder that Hollywood executives aim to please.

For instance, Disney's Marvel Studios produced two versions of the 2013 box office hit *Iron Man 3*. One version was produced for general release, and another version was specifically targeted for Chinese moviegoers. This version included bonus footage in Beijing and guest appearances by Chinese movie stars. In addition, the hits *Mission Impossible III* and *Skyfall* were edited for the Chinese market to cut scenes that Chinese censors thought portrayed China in a negative light, even though several key scenes from these films were set in China.

Some critics assert that Hollywood's accommodating of Chinese preferences is going too far, and amounts to pandering. For instance, in *The Martian*, released in 2015, NASA had to accept help from its counterpart, the China National Space Administration, to provide a classified booster rocket that would carry payload to Mars and thus allow NASA (which did not have such an advanced rocket at its disposal) to rescue its stranded astronaut.

The Great Wall (released in China in December 2016 and in the United States in February 2017) marked a new level of U.S.-China collaboration in

EXHIBIT MC16.2 / Box Office Revenue in the United States and China, 2000–2020



SOURCE: Depiction of data from IHS Markit (with projections for U.S. beginning in 2016 and China in 2017).

movie production. Directed by Zhang Yimou, who rose to fame when he choreographed the opening and closing ceremonies of the 2008 Beijing Summer Olympic Games, the movie co-stars Damon and Jing Tian. Damon plays a European mercenary who joins forces with a Chinese commander, played by Jing Tian, to fight mysterious invaders at the Great Wall. With a mega-budget of \$150 million, *The Great Wall* is the most ambitious coproduction between Hollywood and Chinese film studies to date. It is also the most expensive movie ever shot exclusively in China. As an official coproduction between U.S. and Chinese companies, *The Great Wall* combines cast and effects from both countries and could offer a template for future American-Chinese movies.

Although the hope was that *The Great Wall* would appeal to both Chinese and U.S. audiences, the movie flopped in the United States. Critics highlight the difficulties of creating movies that blend Eastern and Western stories and characters. To produce *The Great Wall*, the companies had to retain more than 100 interpreters to deal with conflicts among cast and crew members based on different cultural understandings. In the United States, *The Great Wall* made only some \$35 million, against a total estimated loss of \$75 million. Yet movie studios are undeterred. They admit that although *The Great Wall* was a commercial failure, they blame that in part on negative reviews. Movie executives continue to highlight the huge market opportunities in China and emphasize that they will soon find the right formula to make movies that are attractive to both U.S. and Chinese audiences.

Challenges with the Chinese Market

Although the Chinese market clearly provides a potentially huge upside for Hollywood, this opportunity does not come without its challenges. One serious challenge is content editing by government officials before screening. The Oscar-winning film *Django Unchained* saw its release in China temporarily canceled due to “technical reasons,” which were interpreted to mean excessive violent and sexual content. By the time the film was recut and released, it performed poorly, in part driven by the fact that many Chinese filmgoers had already seen the film unedited on pirated DVDs. The remake of the film *Red Dawn* was digitally edited in postproduction to change the invading Chinese army to an army from North Korea to avoid offending the

Chinese consumer (and government officials approving the screening of foreign movies).

China is also infamous for rampant infringement of copyright, resulting in a flourishing market for bootleg content. In 2010, a Chinese government report found that the market for pirated DVDs was \$6 billion. As a comparison, the total box-office revenues in China in 2010 were a mere \$1.5 billion. One reason is that ticket prices for movies in China are steep and movies are still considered luxury entertainment that few are willing to pay for. Another reason that black-market sales in China are so high is that legitimate sales often are not allowed. As mentioned, China allows only a few dozen new non-Chinese movies into its theaters each year. Additionally, it has strict licensing rules on the sale of home-entertainment goods. As a result, there is often no legitimate product competing with the bootleg offerings available via DVD and the internet in China.

With the move from physical media such as DVDs and Blu-ray discs to online streaming, Chinese streaming and video-on-demand services are growing rapidly. In 2016, PPTV, a Chinese online streaming website, secured the post-theater rights to *Warcraft* for \$24 million, indicating a potentially new source of revenues for Hollywood. While Netflix does not yet do business directly in China, and the government blocks computers in China from accessing Netflix’s service, it is estimated that 20 million Chinese access Netflix using proxy servers that mask the actual location of the user’s machine. Netflix’s original series *House of Cards* has been a huge success not only in the United States but also in China. In 2017, Netflix came one step closer to directly accessing the China market. It signed a licensing agreement with video platform IQiyi, owned by Chinese internet search company Baidu, which will stream its original content. Netflix content, however, could give Chinese regulators pause. The *House of Cards* plotline, for example, involves a corrupt Chinese businessman operating at the highest level of politics.

Enter Bollywood

The huge opportunities in the global movie market have also attracted new entrants. Besides wanting to cater to international audiences, Hollywood film studios are also feeling squeezed by low-cost foreign competition. While certainly not number one in terms of revenue, India’s Bollywood films have long been

king in terms of total ticket sales. Although generally smaller-budget productions than Hollywood, the Hindi film industry in Bollywood produces four times as many films per year. Moreover, Bollywood brings in low-cost but high-impact actors such as Freida Pinto and Dev Patel, who played the lead roles in the mega-success *Slumdog Millionaire*. *Slumdog*'s budget was merely \$14 million, but the movie grossed almost \$400 million and won eight Oscars. By comparison, Hollywood's budget for *Home Alone*, a similar success in terms of revenues, was nearly five times as large. Globalization also puts pressure on the pay of Hollywood stars. Given the importance of international audiences and the availability of foreign stars and movies, the days are over when stars such as Tom Hanks, Angelina Jolie, Denzel Washington, or Julia Roberts could demand 20 percent royalties on total ticket sales.

DISCUSSION QUESTIONS

1. How has the global environment changed for U.S. (Hollywood) movie studies since 2000? Explain.
2. Apply the integration-responsiveness framework to describe which global strategy Hollywood studios followed originally, and how their strategic positioning has changed over time. Explain how and why.
3. When commenting on the disappointing performance of *The Great Wall*, movie executives continue to highlight the huge market opportunities in China, and emphasize that they will soon find the right formula to make movies that are attractive to both U.S. and Chinese audiences. Do you agree with this assessment? Why or why not?
4. Assuming that movie studios will be able to create breakthrough hits that are attractive for both Eastern and Western audiences, what type of global strategy would that entail? What are some benefits of this type of global positioning? What are some of its risks? Why is this type of global positioning so hard to achieve?
5. What can movie producers do to ensure that future Chinese-U.S. co-productions are more successful? Explain.

Endnote

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MiniCase 17

Samsung Electronics: Burned by Success?

WITH \$176 BILLION in revenues in 2017, Samsung Electronics is the crown jewel of Samsung Group, with its mobile division contributing some 75 percent of the conglomerate's overall profits. The Samsung Group is one of the biggest conglomerates globally. In comparison, the U.S. conglomerate General Electric had some \$150 billion in revenues, while the Tata group of India registered \$104 billion in the same year. Indeed, Samsung is the largest *chaebol* in South Korea, making up one-third of the entire stock market domestically, and it is the country's biggest exporter. *Chaebols* are family-owned multinational companies typical of South Korea, whose economy is dominated by a small number of *chaebols* (including LG, Hyundai, Kia Motors, SK Group, and others).

As impressive as the achievements of the largest *chaebol* in South Korea may sound, Samsung Electronics is facing a host of challenges, creating a perfect storm that calls into question Samsung's future viability. In recent years, the Korean conglomerate has been beset with crises, including:

- **Leadership.** Lee Kun-hee, Samsung's iconic chairman and long-time leader, remains incapacitated after a heart attack in 2014. This situation is creating a leadership vacuum.
- **Product recall.** In 2016, Samsung's flagship phone, the Galaxy Note 7, was withdrawn from the market after some of the new phones spontaneously exploded and caught on fire.
- **Political scandal.** In 2017, Lee Jae-yong, the de-facto leader of Samsung (and son of Lee Kun-hee), was arrested and charged with bribery, embezzlement, and perjury in the wake of the scandal surrounding former South Korean President Park Geun-hye.

Before taking a closer look at the current challenges, we need first to understand a bit of Samsung's storied history and its role in the South Korean economy.



An exploded Samsung Galaxy Note 7.
©AP Images/Shawn L. Minter

Humble Beginnings

In 1938, when the Western world was still recovering from the Great Depression and World War II was about to break out, Lee Byung-chul started a small trading company in Korea (at that time still under Japanese occupation). He named the trading company Samsung, which means three stars in Korean, symbolizing big, powerful, and numerous. Samsung started with just 40 employees and sold noodles and dried seafood. It has since diversified into various industries, including electronics, chemicals, pharmaceuticals, shipbuilding, financial services, and construction. As a result, Samsung today is a widely diversified conglomerate with over 80 standalone subsidiaries. The sprawling *chaebol* has 490,000 employees more than Apple, Google, and Microsoft combined. Not surprisingly, the huge enterprise exerts a powerful influence

Frank T. Rothaermel prepared this MiniCase from public sources. He gratefully acknowledges research assistance by Rahul Singh. This MiniCase is developed for the purpose of class discussion. It is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: August 25, 2017. © Frank T. Rothaermel.

on South Korea's economy, but also on its politics, media, and culture.

The rise of Samsung Electronics began in 1970 when it introduced its first consumer electronics product, a 12-inch black-and-white television. Although it was a latecomer, Samsung made a breathtaking ascent in consumer electronics. It is now leading a number of key electronics industries globally. For instance, since 1993, Samsung Electronics has been the world's largest producer of memory chips. The original iPhone even ran on chips made by Samsung. The company is also the largest television manufacturer in the world, as well as the largest manufacturer of LCD panels. Today, Samsung Electronics produces some 98 percent of all AMOLED screens (unlike LCD screens, AMOLED screens do not need backlight), used in computer monitors, TVs, phones, cars, and elsewhere. Since 2012, Samsung has also been the world's largest phone manufacturer, replacing Nokia at the top spot. Its mobile devices contribute some 75 percent of the conglomerate's overall profits. In 2017, Samsung also overtook Intel as the largest chipmaker in the world.

The person credited for this tremendous ascent to world leadership in consumer electronics is Lee Kun-hee, the youngest son of the founder, who took over as chair of the conglomerate in 1987. Lee Kun-hee was trained in Western management principles, earning an MBA from George Washington University. To a culture that deeply values seniority, he introduced merit-based pay and promotion. His strategic intent was to make Samsung a world leader in high-tech industries, including consumer electronics. To execute his strategy, Lee Kun-hee focused first on gaining market share by invading markets from the bottom up with lower-priced products at acceptable value. He hired Western managers and designers into leading positions and sent homegrown talent to learn best business practices from other firms wherever they could be found. Lee Kun-hee also set up the Global Strategic Group to assist non-Korean MBAs and PhDs with a smooth transition into their positions in a largely homogenous cadre of Korean executives.

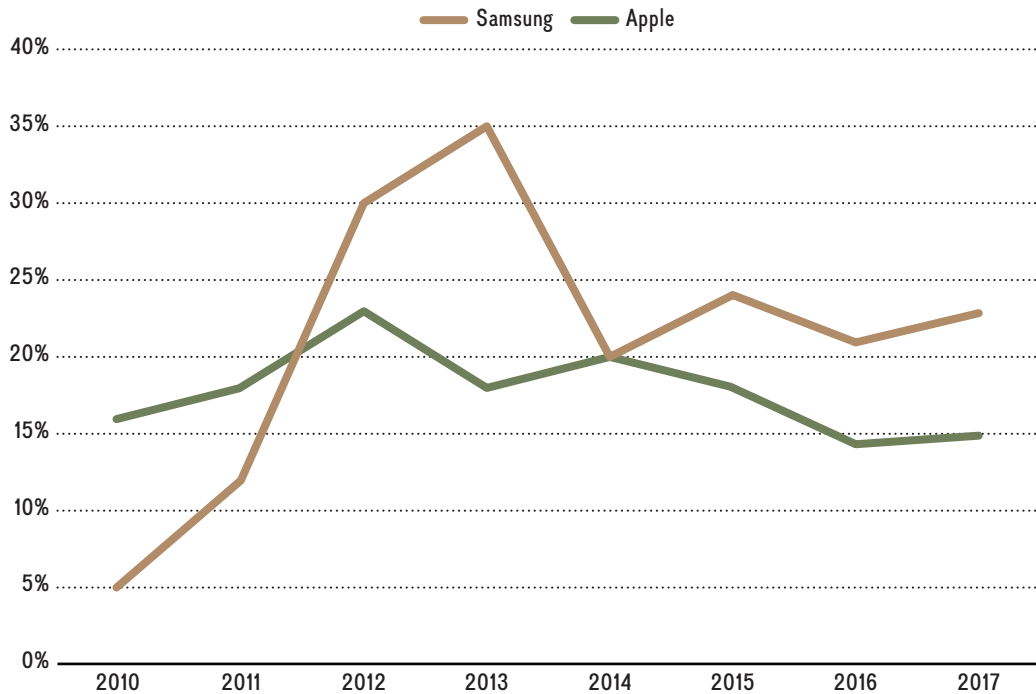
Positioning Samsung Electronics for Global Leadership

In the 1990s, Samsung's image, however, was still overshadowed by those of Sony, Motorola, and Nokia, the undisputed world leaders in consumer electronics

and mobile phones. During a 1993 trip, Lee Kun-hee saw firsthand how poorly Samsung's electronics were perceived in the United States and Europe, and he vowed to change that. Back in Korea, to show his disappointment and determination alike, he destroyed 150,000 new Samsung cell phones in a large bonfire in front of all 2,000 employees of Samsung's Gami factory. Many employees credit this as the pivotal moment in redefining Samsung Electronics' strategic focus and initiating a successful turnaround. Under Lee Kun-hee's leadership, Samsung Electronics significantly increased spending on research and development (R&D) as well as on marketing and design. Once economies of scale due to a larger market share could be reaped, he moved Samsung to the high end of the market, offering premium consumer electronics such as flat-screen TVs, appliances, semiconductors, and mobile devices, including its famous Galaxy line of smartphones.

In 2007, Apple introduced the iPhone, redefining the entire category of mobile phones and setting the standard for the way smartphones looked and felt. Samsung played catch-up again, ratcheting up spending on R&D and marketing. In particular, the company applied its time-tested "follow first, innovate second" rule. As a key component vendor to other leading technology companies including Apple, Samsung Electronics saw early on what directions other companies were taking. Within a short time, it had overtaken Motorola, HTC, BlackBerry, Nokia, and even Apple to become the number-one vendor of smartphones in the world and the largest technology company globally by revenues, and held the largest market share by units (see Exhibit MC17.1). By 2012, with the release of its Galaxy S III phone, Samsung had successfully imitated the look and feel of the Apple iPhone. Apple and Samsung, however, have been locked in ongoing court battles over infringement among the various smartphone models. Samsung lost a high-profile case against Apple in a California court in 2015, where damages were later reduced to some \$500 million.

Despite the temporary competitive advantage Samsung achieved in 2012, within several years it stumbled, with revenues and profits down sharply from its peak in 2013 (see Exhibit MC17.2). Although it sells fewer phones than Samsung, Apple's profit margin per phone is much higher. With the introduction of the iPhone 6 in 2014, Apple again pulled away from Samsung. With the larger screen on the iPhone 6 Plus, Apple

EXHIBIT MC17.1 / Samsung vs. Apple: Global Smartphone Market Share by Units (in %), 2010–2017

SOURCE: Depiction of publicly available data. Data for 2017 is based on Q1.

also negated Samsung's lead with its successful Galaxy Note phablets. Apple followed up with the iPhone 7 in 2016 and its 10th anniversary model in 2017. With a string of incremental innovations, Apple has continued to capture a greater share of the high end of the market. Although Apple's market share in terms of units in the global smartphone industry is less than 20 percent, it captures a whopping 92 percent of all the profits generated in the industry!

Struggles at Samsung Electronics

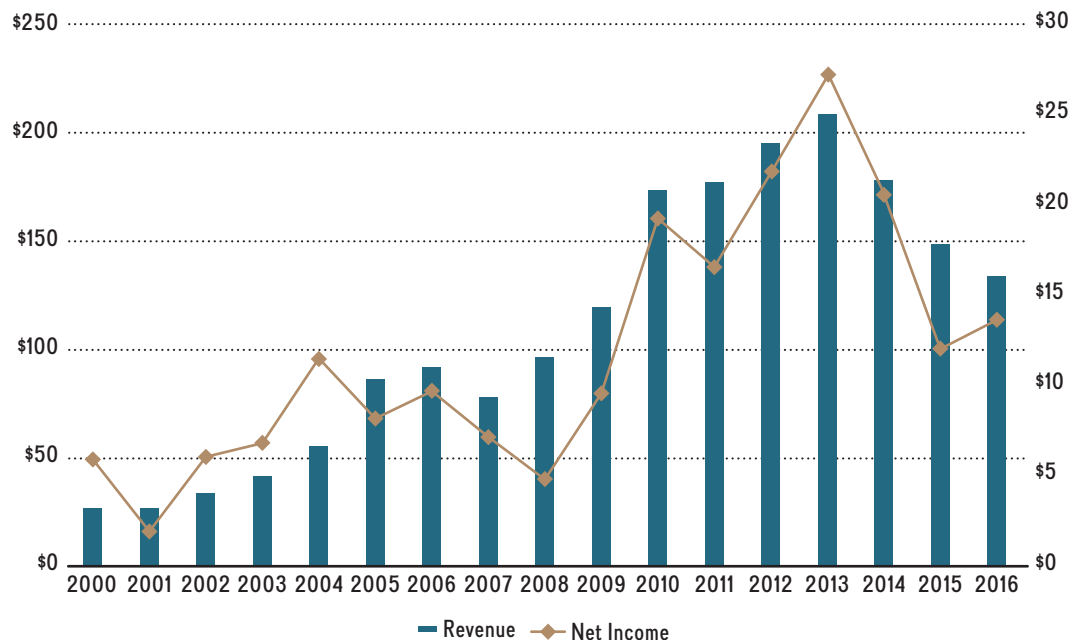
Samsung Electronics not only lost market share on the high end of the mobile phone market, but also on the low end. Chinese technology companies Oppo, Huawei, and Xiaomi are becoming more and more popular. In particular, the Chinese startup Oppo has challenged Samsung and Apple in consumer markets with huge growth potential such as China. By 2017, Oppo, often described as China's Apple, had become the

number-one seller of smartphones in China by units. Similarly, by launching new smartphones quickly, almost like fashion accessories, India's Micromax had become the number-one seller in its home market.

Samsung Electronics is being squeezed in the middle. On the high end, it has fallen behind Apple, which continues to pull away with its innovation and design setting new standards for the most profitable segment of the market. On the low end, upstarts from China and India are capturing leading positions in markets with huge growth potential. Within the company, the soul-searching about Samsung's future has begun. In 2010, Lee Kun-hee set the strategic intent that Samsung should quadruple its revenues from \$100 billion to \$400 billion by 2020 (which would be more than the revenues of Apple, Google, Microsoft, and Amazon combined).

By 2016, the situation for Samsung Electronics was getting worse. From selling well over 30 percent of all mobile phones globally, its market share had fallen to 18 percent by the end of the year.

EXHIBIT MC17.2 / Samsung Electronics Revenues (left vertical axis) and Net Income (right vertical axis) in \$ billions, 2000–2016



SOURCE: Depiction of publicly available data.

Three Crises in Four Years

During the struggles identified above, which may seem part of the rough and tumble of high-stakes competition, Samsung had to face three separate crises that rocked the company further: leadership struggles, product recalls, and political scandal.

LEADERSHIP STRUGGLES. Although the business situation for Samsung Electronics seems to be improving, its downward spiral for the past few years coincided with Lee Kun-hee's heart attack in 2014, which left him incapacitated. The 75-year-old had ruled Samsung with an iron fist: No strategic or personnel decisions were made without his approval. With the leadership vacuum, the turf battle for Samsung's top job began, with many observers convinced that Lee Kun-hee's only son, Lee Jae-yong (who goes by Jay Lee), was the heir apparent. Prior to his arrest and charge in 2017, the younger Lee held the position of vice chairman within the Samsung Group. At the same time, Samsung Electronics currently has an unusual leadership structure, with three co-CEOs each acting as the leader of his respective division (components,

mobile, and consumer electronics). The involvement of the Lee family in Samsung is persistent throughout the conglomerate, however, with descendants of the company's founder serving in multiple leadership positions.

Lee Jae-yong holds a relative small stake in Samsung Electronics, which is key to running the entire conglomerate. At the same time, activist shareholders such as Elliott Management of the United States are pushing to restructure the Samsung conglomerate to provide more transparency in its governance structure, and to break open the tight grip that some Korean families have over the *chaebols*, despite fairly small share holdings. The younger Lee also faces billions in inheritance taxes when his father dies.

PRODUCT RECALL. Samsung Electronics was already dealing with shrinking margin share, when it encountered the Galaxy Note 7 debacle. The Note line of mobile devices are Samsung's phones with larger screens, in which the South Korean company had been leading Apple. The new Note 7 was introduced in the summer of 2016 to great fanfare and raving reviews (e.g., "best phone ever").

But just a few days after its launch, reports of spontaneous explosions and fires that the new smartphone was experiencing started to circulate in the media. Rushing to contain the looming problem, Samsung Electronics blamed a faulty battery from a specific supplier. It decided to no longer use this particular supplier and exchange all the phones already sold with new Note 7 phones that contained batteries from a different supplier. Alas, this did not solve the problem. The media storm was gathering strength as more and more reports of spontaneous phone explosions and resulting fires came in. In the United States, the Federal Aviation Administration acted swiftly by banning all Samsung Galaxy Note 7 phones from flights. Flight crews made announcements before every flight, reminding each traveler of the problems Samsung was facing with its Note 7 at about the same time as Apple was introducing the new iPhone 7, which turned out to be a bestseller. After recalling millions of Note 7 phones globally, Samsung announced in October 2016 that it would permanently end production and sale of the tarnished smartphone.

In the spring of 2017, Samsung launched its new Galaxy S8 (a smaller version, not related to its Note line of phone) with considerable success. In the same year, Samsung Electronics also reported record profits as demand for the Galaxy S8 and the company's microchips was strong.

POLITICAL SCANDAL. The leadership challenges facing Lee Jae-yong may have also led to events that embroiled him in a political scandal. In 2017, prosecutors accused him of bribery, embezzlement, and perjury. He was subsequently arrested, becoming the first Samsung leader to land in jail. (His father, Lee Kun-hee, was convicted in 2008 for embezzlement and tax evasion, but later received a presidential pardon.)

In the case of the younger Lee, prosecutors allege that he sought South Korean President Park Geun-hye's support and influence in a controversial merger of two Samsung affiliates. Lee Jae-yong, who holds only a 0.6 percent share in Samsung Electronics, needed the merger to go through to generate much-needed cash, and more importantly to strengthen his hold on Samsung Electronics, ensuring a smooth leadership transition along the Lee family lines. And one reason he may have needed that cash was to deal with the inheritance taxes relative to his share of Samsung Group. To achieve his goal, Lee Jae-yong turned to President Park, prosecutors allege, who in turn influenced Korea's National

Pension Service to cast the deciding vote in favor of the proposed merger within the Samsung conglomerate. The National Pension Service obliged, even though it was losing money in the transaction.

To ensure continuation of the cozy relationship between politics and business in South Korea, Samsung made a \$38 million "donation" to foundations held by a close friend of the president, Choi Soon-sil. She is one of the key figures in the scandal rocking South Korea because prosecutors allege that Choi Soon-sil had a huge influence on the president's decisions and access to confidential government papers, despite not holding any formal position. Park Geun-hye is the first Korean president to be impeached. Charges against her include abuse of power, bribery, and leaking of government secrets. Caught up in the presidential scandal, Lee Jae-yong, Samsung's de-facto leader and figurehead, was convicted of bribery in the summer of 2017, and sentenced to five years in jail. His attorneys immediately appealed the ruling. In the meantime, Samsung's leadership vacuum continues.

DISCUSSION QUESTIONS

Corporate Strategy and Governance

1. What makes Samsung a conglomerate? What type of diversification does Samsung pursue? Identify possible factors such as core competencies, economies of scale, and economies of scope that were the basis of its past success as a widely diversified conglomerate. Why is Samsung as a conglomerate struggling today?
2. Despite being a widely diversified conglomerate, Samsung prefers vertical integration: in-house design and development teams, manufacturing in large company-owned factories, and coordinating a sprawling global supply chain. In contrast, Apple concentrates on the design (and retail sales) of high-end mobile devices, while it outsources its production to Foxconn and others. Do you think Samsung's high degree of vertical integration contributed to its recent problems? Why or why not? Explain.
3. What is a *chaebol*? What are some of the corporate governance challenges that *chaebols* such as Samsung face? What are some of the advantages and disadvantages of *chaebols*? What changes to a *chaebol's* governance structure are American activist investors such as Elliott Management pushing for, and why?

4. With South Korea being rocked by the presidential scandal exposing a deep-running and long-standing nexus of bribery and chummy relationships between industry and politicians, and by the call for more transparency and governance changes in the *chaebols*, do you think reform and changes will happen, or will things return to business as usual? What is your opinion? Explain.

Business Strategy

5. Lee Jae-yong, the 50-year-old grandson of the Samsung founder, was educated at Seoul National University, Keio University (in Japan), and Harvard Business School. He wrote a master's thesis at Keio University on Japan's struggle to retain its world leadership in manufacturing in the mid-1990s when the country's fast-growing period was ending. He concluded, "Japan's troubles were worsened by its manufacturers' pursuit of scale and market share."¹ Is Samsung Electronics' pursuit of scale and market share to blame for its losing its competitive advantage?
6. Why is Samsung Electronics encountering problems selling its flagship line of smartphones, the Galaxy? How should it compete against premium phone makers such as Apple and low-cost leaders such as Oppo and Micromax? Do you think

Samsung will be making a comeback with its Galaxy line of phones? Why or why not?

Endnote

1. Cheng, J., and Lee, M. J. (2015, May 11), "After Galaxy smartphone debacle, Samsung questions game plan," *The Wall Street Journal*.

Sources: Jeong, E.-Y. (2017, Aug. 25), "Samsung Heir Lee Jae-yong Convicted of Bribery, Gets Five Years in Jail," *The Wall Street Journal*; Tsang, A. (2017, July 7), "Samsung, seeking to move past scandals, forecasts record profit," *The New York Times*; Fowler, G. (2017, Apr. 18), "Samsung Galaxy S8 review: Great phone, but that's not all that matters," *The Wall Street Journal*; Jeong, E.-Y., and T. W. Martin (2017, Apr. 7), "Samsung heir takes center stage in South Korea's 'trial of the century,'" *The Wall Street Journal*; Mozur, P. (2017, Jan. 22), "Galaxy Note 7 fires caused by battery and design flaws, Samsung says," *The New York Times*; Song, J., K. Lee, and T. Khanna (2016), "Dynamic capabilities at Samsung: Optimizing internal co-opetition," *California Management Review* 58 (4): 118–140; "Charred chaebol," *The Economist*, October 15, 2016; Bellman, E., and R.J. Krishna (2015, June 4), "India's Micromax churns out phones like fast fashion," *The Wall Street Journal*; "Samsung: The soft succession," *The Economist*, May 23, 2015; Cheng, J., and M.-J. Lee (2015, May 11), "After Galaxy smartphone debacle, Samsung questions game plan," *The Wall Street Journal*; Cheng, J. (2015, May 11), "What to know about Samsung," *The Wall Street Journal*; Cheng, J. (2015, Mar. 1), "Samsung unveils Galaxy S6 to answer iPhone 6," *The Wall Street Journal*; Cheng, J. (2014, Oct. 27), "Samsung's primacy is tested in China," *The Wall Street Journal*; Lee, M.-J. (2014, Oct. 7), "Samsung girds for cost cuts after downbeat guidance," *The Wall Street Journal*; "Samsung: Waiting in the wings," *The Economist*, September 27, 2014; "How Samsung got big," *TechCrunch*, June 1, 2013; "The rise of Samsung and how it is the mobile reshaping ecosystem," *Business Insider*, March 14, 2013; "Faster, higher, stronger: The rise and rise of Samsung," *The Sydney Morning Herald*, August 13, 2012; "Samsung: the next big bet," *The Economist*, October 1, 2011; "Samsung and its attractions: Asia's new model company," *The Economist*, October 1, 2011; Khanna, T., J. Song, and K. Lee (2011), "The paradox of Samsung's rise," *Harvard Business Review*, July–August; and various Samsung Annual Reports.

MiniCase 18

Does GM's Future Lie in China?

GIVEN THE SHEER SIZE OF THE U.S. automotive market, the “old” GM concentrated mainly on its domestic market. GM once held more than 50 percent market share in the United States and was the leader in global car sales (by units) between 1931 and 2007, before filing for bankruptcy in 2009.¹ In its heyday, GM employed 350,000 U.S. workers and was an American icon.

The future for the “new” GM may lie overseas, most notably in China. Some 65 percent of GM's revenues are now from outside the United States. This is quite a high level of globalization for a company that once was focused more or less on the domestic market only. The Chinese market is becoming more and more important to GM's performance. In 2016, GM sold 3.9 million vehicles in China alone, which is 39 percent of total GM cars sold. As shown in Exhibit MC18.1, China's share of GM's total sales is on a steady climb, reaching 40 percent of total revenues in 2017 (Q1).

With a population of 1.4 billion and currently only 11 vehicles per 100 people—compared with a vehicle density of 81 per 100 in the United States—China offers tremendous growth opportunities for the automotive industry. Since China joined the World Trade Organization (WTO) in 2001, its domestic auto market has been growing rapidly and has now overtaken the United States as the largest in the world. Although the growth of the Chinese auto market has slowed in recent years because of the economy's downturn, GM CEO Mary Barra remains convinced that China offers significant long-term growth opportunities.

Unlike some of its main rivals, GM entered the Chinese market early. In 1997, GM formed a joint venture with Shanghai Automotive Industrial Corp. (SAIC), one of the “big four” Chinese carmakers. SAIC is one of the largest companies worldwide and included in the Fortune Global 100 list (ranked 46th, just behind Amazon.com and before Hewlett-Packard).² Over 30 years, GM was able to develop *guanxi*—social networks and relationships that facilitate business dealings—with its Chinese business partners and government officials.

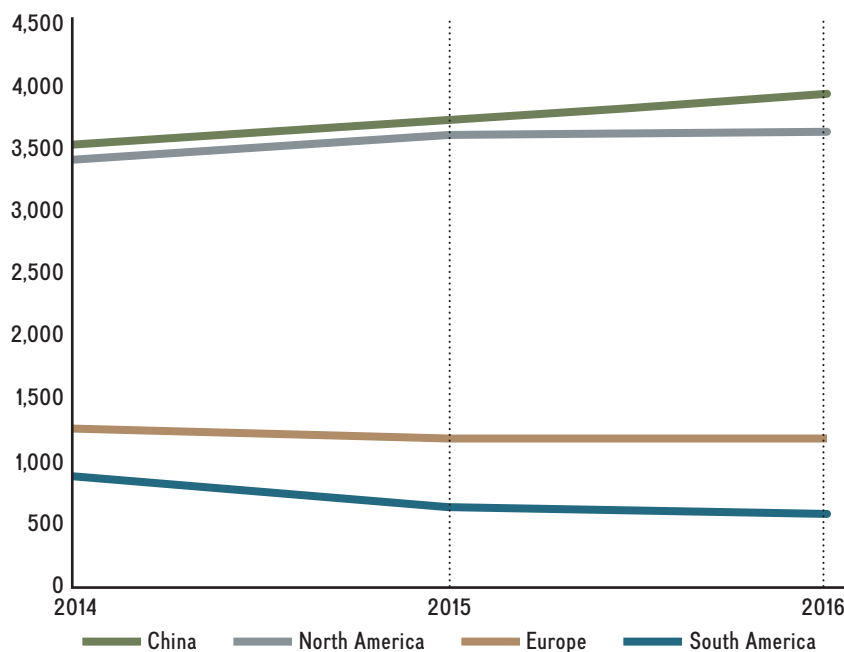


Mary Barra, CEO General Motors, is refocusing GM on the U.S. home market and China, among other developing economies, while exiting Europe.

©Tomohiro Ohsumi/Bloomberg/Getty Images

GM's China operation has been cost-competitive from day one. The company operates about the same number of assembly plants in China as in the United States, but sells more vehicles while employing about half the number of employees. Chinese workers cost

Frank T. Rothaermel prepared this MiniCase from public sources. He gratefully acknowledges research assistance by Rahul Singh. This MiniCase is developed for the purpose of class discussion. It is not intended to be used for any kind of endorsement, source of data or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: July 3, 2017. ©Frank T. Rothaermel.

EXHIBIT MC18.1 / GM's Number of Vehicles Sold by Geographical Location (in thousands), 2014–2016.

SOURCE: Depiction of data from 2016 GM Annual Report.

only a fraction of what U.S. workers do, and GM is not weighed down by additional health care and pension obligations.

Although struggling in the United States, GM's Cadillac luxury brand is in high demand in China, where owning a Cadillac is considered a status symbol. GM's best-selling model in China, however, is the Wuling Sunshine, a small, boxy, purely functional micro van priced between \$5,000 and \$10,000 depending on what options the customer chooses. The SAIC-GM joint venture sold almost 2 million Wuling vehicles in China in 2014. The Wuling Sunshine may help GM further penetrate the Chinese market; it also may be an introductory car for other emerging markets. GM's low-cost strategy with this vehicle has been so successful that the firm is planning to expand the Wuling product line and offer the vehicle globally. GM already sells the Wuling Sunshine in Brazil under the Buick nameplate.

Among GM's most profitable vehicles sold in China are such popular SUVs as the Baojun 560 and the Buick Envision (the latter of which is made in China and then imported to the United States, where it is also selling

well). Since 2013, Buick's sales in China have risen by almost 50 percent; in 2016 alone, GM sold more than 1 million Buick vehicles. However, sales of Chevy, another GM brand, have fallen by some 16 percent. Despite being offered at a higher price point, GM sold twice as many Buicks as Chevrolets in China.

Taken together, China and other emerging economies in Asia, Latin America, and the Middle East are becoming more and more critical to GM's future performance as it strives to become a lean and low-cost manufacturer of profitable small cars (at least for its non-U.S. markets). To back up its strategic intent, GM has quadrupled its engineering and design personnel in China and is investing \$250 million to build a cutting-edge R&D center on its Shanghai campus, home of its international headquarters. Also, GM is spending an estimated \$14 billion to build five additional manufacturing plants to support anticipated annual sales of 5 million vehicles.

At the same time that GM is doubling down on China, it has exited Europe. In 2015, GM stopped manufacturing cars in Russia, citing unstable business conditions as the main reason. After years of losing

money and acrimonious parent–subsidiary relationship, GM sold its Opel (Germany) and Vauxhall (United Kingdom) divisions to Peugeot of France in 2017. In the same year, Barra also announced that the U.S. automaker will discontinue selling cars in India. This further retrenchment will allow GM to focus more on China and Brazil overseas, and to fend off tech startups such as Tesla and Uber in the United States, where it made an equity investment in Lyft, which in turn partnered with Waymo, Alphabet's self-driving car unit.

For Mary Barra, unfortunately, not everything in China will be smooth sailing. Given the slowdown in the Chinese economy, combined with continual devaluation of the Chinese currency (the yuan) since 2014, the competitive intensity in the world's largest automobile market is becoming more intense. Moreover, several government-supported domestic car manufacturers in China are initiating a cutthroat price war to gain market share and, with it, scale. For instance, GM's own joint venture partner SAIC as well as other domestic companies such as Great Wall Motor Co. are increasingly competing with GM for market share. As the quality and technology expertise is rapidly increasing at domestic car manufacturers, many Chinese consumers are increasingly turning to local brands instead of the pricey foreign models from the United States and Europe. At the premium end of the Chinese market, brands such as Porsche or Audi (both are Volkswagen brands) remain the most popular choices. In contrast, low gas prices in the United States in recent years have fueled high demand for sport utility vehicles (SUVs) and trucks—an area where GM and Ford hold strong positions. These types of vehicles are also the most profitable for the U.S. automakers to sell.

DISCUSSION QUESTIONS

1. How important are non-U.S. sales to GM? What implications does this have for GM's global and business strategy? Think about the integration-responsiveness framework to inform global strategy and different strategic positions to inform business strategy.
2. In 2016, GM held almost 15 percent market share in China, while Ford held only 3 percent. Why was GM so successful in China, while some of its rivals, including Ford, struggled to gain a stronger position in the world's largest automobile market?
3. What are the challenges GM is currently facing in the Chinese automobile market? How should GM's CEO address them? Be specific.

Endnotes

1. Keep in mind that selling a large volume of cars doesn't make a company profitable, if the cars are sold at a low margin or even at a loss. In contrast, Ferrari sells only some 7,500 vehicles a year, but is highly profitable (not surprising because the sticker price of the entry-level Ferrari is \$200,000).
2. Fortune's Global 500 (2016), <http://fortune.com/global500/saic-motor/>, accessed July 3, 2017.

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MiniCase 19

Flipkart vs. Amazon in India: Who's Winning?

FLIPKART'S MANTRA IS “*Ab Har Wish Hogi Poori*” or “Every wish fulfilled.” For the time being, the Indian ecommerce company has fulfilled its own wish. With a valuation of close to \$12 billion in 2017, Flipkart (www.flipkart.com) is one of the 10 most valuable privately held startups. It is in fine unicorn company along with Uber, Didi Chuxing, Airbnb, and SpaceX, all privately held startups valued between \$12 billion and \$70 billion. The stated goal of the co-founders, Sachin Bansal and Binny Bansal is to make Flipkart India's first \$100 billion ecommerce company.¹

With \$11 billion in sales in 2015, India's ecommerce market is still in its infancy. In comparison, China's ecommerce sales in 2016 were a whopping \$900 billion. With rising internet penetration in India (see Exhibit MC19.1) and a rising middle class of young, well-educated urban professionals, India's ecommerce is expected to reach \$130 billion by 2025.

How Flipkart Took an Early Lead

The leading ecommerce company in India is not one of the global giants such as Amazon or Alibaba, but the homegrown Flipkart. Founded in 2007 by Sachin Bansal and Binny Bansal (same last name, but unrelated), Flipkart began its life just like Amazon.com: selling books online at discounted prices. To many observers, this was not surprising because the co-founders met while working at Amazon.com. They are also both graduates of India's most prestigious university system: the Indian Institute of Technology (IIT). Flipkart continues to recruit the best and the brightest engineers from IIT.

Flipkart had humble beginnings, as Bansal and Bansal set up the company from their two-bedroom apartment in Bangalore with an initial investment of \$8,000. What began as selling books is now disrupting retailing in India. In this land of over 1.2 billion people, more than 50 percent of its population is age 25 or younger and more than 65 percent is below the age of 35. In 2020, the average Indian will be 29 years old, while the average Chinese will be 37;



TOP: Sachin Bansal (left) and Binny Bansal (right; no relation) are the co-founders of Flipkart. Valued at close to \$12 billion, it is India's most valuable retail company. **BOTTOM:** Jeff Bezos is making a major push into India, with Amazon investing billions. In 2013, Amazon did not exist in India. In the meantime, Bezos lost out to Alibaba in China. He promised not to repeat this outcome in India where Amazon now takes on Flipkart, the early leader in Indian ecommerce.

(top): ©Mint/Hindustan Times/Getty Images; (bottom): ©MANJUNATH KIRAN/AFP/Getty Images

Frank T. Rothaermel prepared this MiniCase from public sources. He gratefully acknowledges research assistance by Amey Sahasrabudhe. This MiniCase is developed for the purpose of class discussion. It is not intended to be used for any kind of endorsement, source of data, or depiction of efficient or inefficient management. All opinions expressed, all errors and omissions are entirely the author's. Revised and updated: August 7, 2017. ©Frank T. Rothaermel.

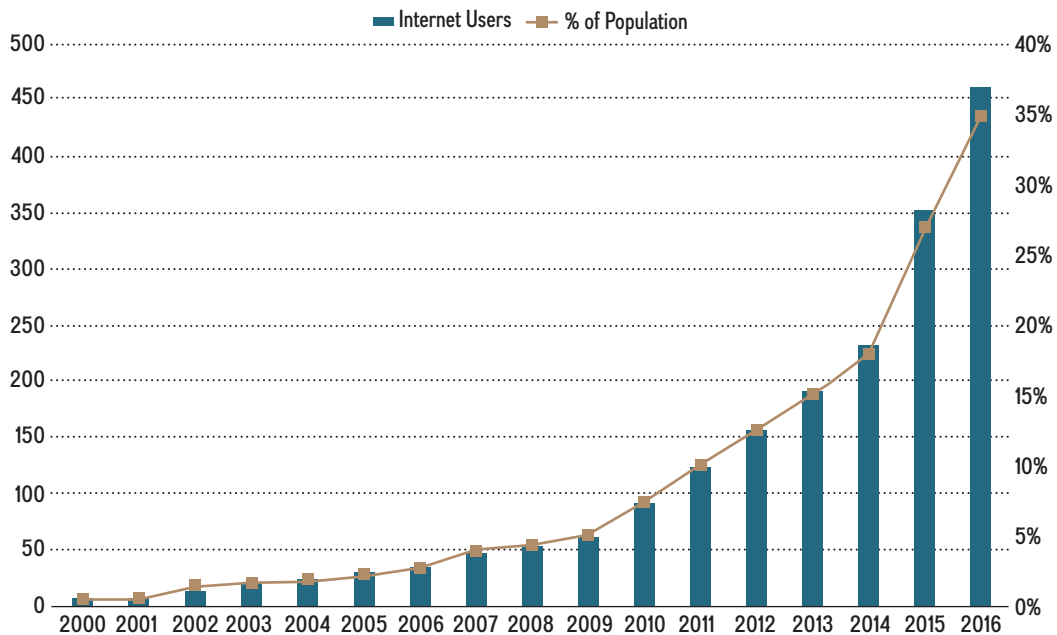
the average American, 42; and the average Japanese, 48. In addition, English is the country's official language, and most younger Indians are well educated and moving rapidly into the middle class. As their disposable income increases, their time to battle the chaotic Indian traffic and inclination to haggle with obstinate vendors decreases. Instead, they are using the internet in ever larger numbers and are conducting more and more transactions online (see Exhibit MC19.1 for growth in internet users).

While Flipkart is certainly benefiting from a first-mover advantage combined with the explosive growth in Indian ecommerce, it was unique tweaks to its business model that set it apart from other online retailers, including American online giants such as Amazon and eBay or the Chinese internet firm Alibaba. In a country like India where fraud is rampant and trust among vendors and customers is low, Flipkart had to first transform the way Indians shopped. It achieved this by tailoring its offerings to the idiosyncrasies of its domestic retail market. Unlike in the United States or Europe, retail transactions in India are mostly cash-based, so credit card penetration is very low (about 1 percent). However, as more of the population relies on the mainstream banking system, so grows its debit card usage.

Even with the availability of plastic money options, many Indians are wary about the security of online transactions using credit or debit cards. Compounding this problem is that most Indians lack access to credit. To overcome these challenges, Flipkart became one of the first major ecommerce players in India to offer a cash-on-delivery (COD) service to online customers in 2010. This went a long way to build credibility and brand value for Flipkart. Some estimates peg the number of COD transactions in Indian ecommerce as high as 80 percent of all sales.

A second and related problem Flipkart addressed is the custom in India for shoppers to buy goods only after a thorough physical inspection of the product at a brick-and-mortar store, often by multiple family members if a larger purchase is being considered. To overcome this challenge, Flipkart introduced a hassle-free return-and-exchange policy. This tactic allowed Flipkart to attract many first-time online buyers, who now make up a significant portion of the company's revenues, which were \$2.3 billion in 2015, up from only \$10 million in 2011. Flipkart's explosive growth in revenues equates to a compound annual growth rate of almost 300 percent! Third, Flipkart also introduced an option to purchase expensive items with its EMI (easy monthly

EXHIBIT MC19.1 / India's Internet Population (in million) and Penetration Rates (in percent), 2000–2016



SOURCE: Depiction of data from "India Internet Users," <http://www.internetlivestats.com/internet-users/india/>.

installments) program. It accomplished this through associations with all major banks. In 10 urban areas Flipkart offers same-day delivery, and it guarantees next-day delivery in more than 65 metropolitan areas.

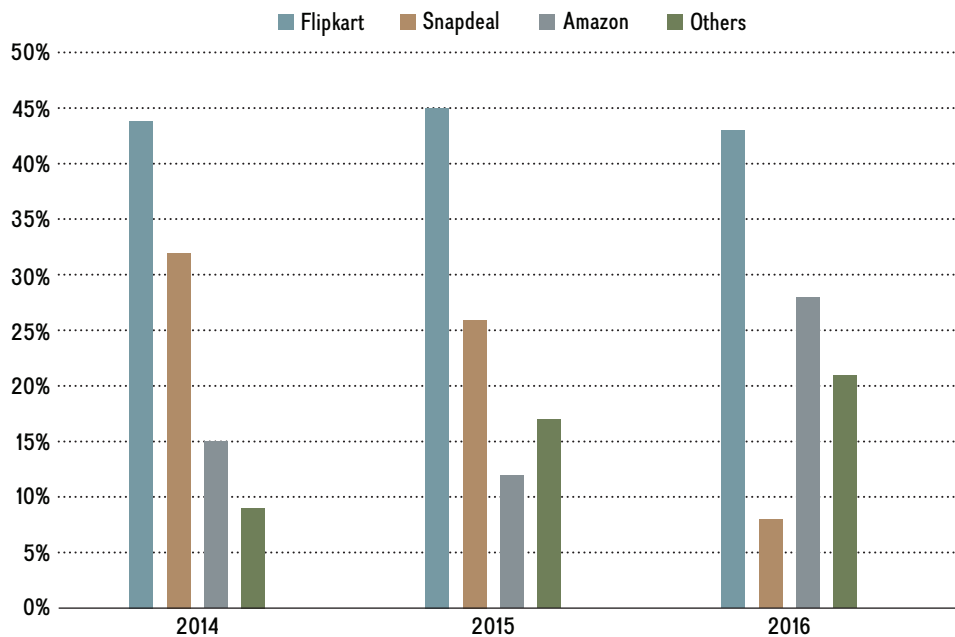
While its business model provided solutions to unique Indian ecommerce challenges, Flipkart diversified quickly into many different product categories. Starting as just an online bookseller, Flipkart now hosts 75 product categories on its platform. Its major product categories include books, electronics and accessories, lifestyle and fashion, home decor, and do-it-yourself products. While books and electronics continue to be its strongholds, lifestyle and fashion are the fastest-growing segments. Because the Indian government continues to bar foreign direct investment in retail companies, Flipkart (which is financed by non-Indian venture capitalists from the United States, the United Kingdom, Russia, and Singapore) had to change its business model. It moved away from Amazon's model of shipping mainly merchandise it owns and that requires storage in its own warehouses to now be more akin to Alibaba, hosting third-party sellers. Flipkart morphed into an online platform that enables other merchants to sell on its website.

It makes money by taking a fee on every transaction occurring on its site.

Amazon Comes to India: The Empire Strikes Back

After Amazon lost out to Alibaba in China, it entered India in 2013 to sell books, DVDs, electronic goods, and fashion accessories (www.amazon.in). This made Amazon.com a latecomer to the Indian ecommerce party. Indian ecommerce companies Flipkart and runner-up Snapdeal (www.snapdeal.com) enjoyed early-mover advantages over Amazon. Both domestic startups were able to leverage deep understanding of the Indian retail market and ecommerce into a competitive advantage (see Exhibit MC19.2). In the summer of 2017, Flipkart offered close to \$1 billion to acquire Snapdeal. Snapdeal's largest shareholder, Japan's SoftBank Group, supported Flipkart's bid to merge both homegrown Indian ecommerce companies in an effort to compete more effectively against Amazon.com. Just a month later, Snapdeal terminated merger talks with Flipkart, and decided to continue going it alone.

EXHIBIT MC19.2 / Market Share of Indian E-tailers, 2014–2016



SOURCE: Depiction of data compiled and constructed from various newspaper articles in *The Economic Times*, *Mint*, and *Business Standard*, and Purnell, N. (2016), "Jeff Bezos invests billions to make Amazon a top e-commerce player in India," *The Wall Street Journal*, November 18.

Jeff Bezos, Amazon's founder and CEO, himself visited Bangalore in 2014. In a Bollywood-like PR stunt, he stepped out of a colorfully decorated Indian truck, dressed in traditional white Nehru jacket, and hand-delivered a surfboard-sized check of \$2 billion to Amit Agarwal, Amazon's India head. Bezos' marching order to Agarwal: Do what it takes to succeed in India and don't worry about the cost. We cannot allow another failure like in China to happen. Amazon has added another \$3 billion of investments in India since.

Although Flipkart innovated with features to match the unique Indian retail environment, the features were easily imitated by Amazon. Indeed, it quickly matched many of Flipkart's tactics such as cash on delivery, installment payment plans, and same-day and next-day deliveries. Like Flipkart, Amazon also offers some 80 million products on its site, while runner-up Snapdeal offered some 50 million. Amazon also offers services that Flipkart cannot yet match, such as the "fulfilled by Amazon" service (in which items offered by a third-party seller on Amazon's site are shipped from an Amazon fulfillment center and all Amazon standard shipping rates and policies apply).

Amazon also brings to bear several advantages that Flipkart cannot match. In particular, Amazon is using its sophisticated U.S. technology now in India, with a powerful search engine based on artificial intelligence that predicts what customers are looking for and what they might buy next. Besides its \$5 billion investments, Amazon has a huge war chest of cash it brings to bear, being valued at \$475 billion in 2017, making it one of the most valuable tech companies globally. Amazon quickly built a network of warehouses in India, especially near large urban areas, which helps with speedy and reliable deliveries. It is building relationships of trust with its customers, delivering products they want such as smartphones at low prices.

As an indication of how fast Amazon is catching up: It reached sales of \$1 billion just one year after it entered India. The same milestone took Snapdeal four years and Flipkart, as the first major entrant, seven years to accomplish. By 2016, Amazon had reached almost 30 percent market share, making it number two in the Indian ecommerce market, closing the gap with Flipkart (see Exhibit MC19.2). It is too early to count out the deep-pocketed and relentless Amazon and its CEO quite yet.

On the other hand, there are some indications that Walmart, Amazon's biggest rival in the United States, is interested in investing or acquiring Flipkart. So the

ecommerce battle for supremacy in India is far from over. In the meantime, India's consumers can benefit from more choice, lower prices, and better service.

DISCUSSION QUESTIONS

1. Why was Flipkart able to achieve an early competitive advantage in India? What is the basis of Flipkart's competitive advantage? Focus on external and internal factors. Separate factors unique to India from more generic factors (fast growth, for example) that may also hold true in other countries.
2. Will Flipkart be able to sustain its early lead over Amazon, given the deep pockets of the U.S. e-commerce giant and its intentions to invest further in India? What are some key advantages that Flipkart has over Amazon? What are some of Flipkart's disadvantages? What would Flipkart need to do to sustain its competitive advantage?
3. Should Flipkart leverage its core competencies outside India to "go global"? If so, which countries do you think would provide the best opportunities for Flipkart, and why? If Flipkart were to go global, what kind of global strategy should it pursue, and where?
4. What kind of global strategy is Amazon pursuing in India? Why is India so important for Amazon? Do you think Amazon will win in India? Why or why not?
5. What will the future look like for Flipkart? Why would Walmart want to acquire Flipkart?

Endnote

1. A unicorn is a privately held startup valued at \$1 billion or more.

Sources: "Flipkart acquisition of Snapdeal collapses as latter decides to go ahead alone," *The Economic Times of India*, August 7, 2017; "Flipkart raises bid for Snapdeal to up to \$950 million," *Reuters*, July 18, 2017; Purnell, N. (2016, Nov. 18), "Jeff Bezos invests billions to make Amazon a top e-commerce player in India," *The Wall Street Journal*; Das, G. (2015, May 24), "The battle of the big boys—Flipkart vs. Snapdeal vs. Amazon," *Business Standard*; "Online retailing in India: The great race," *The Economist*, March 5, 2016; Thoppil, D.A. (2015, May 19), "Flipkart valued at \$15 billion after latest funding," *The Wall Street Journal*; McLain, S. (2015, Feb. 19), "Flipkart is worth more than Airbnb," *The Wall Street Journal*; Austin, S., C. Canipe, and S. Slobin (2015, Feb. 18), "The billion dollar startup club," *The Wall Street Journal*; Sood, V. (2015, Jan. 20), "Amazon India may emerge as fastest e-tailer to touch \$2-bn sales mark," *The Economic Times*; Bhagavatula, S. (2015), "Creative Disruptions—The story of Indian entrepreneurship," YouTube, NSRCEL, Indian Institute of Management Bangalore (IIMB), www.youtube.com/watch?v=vAFIO9-I5rg (2:53 min); Thoppil, D.A. (2014, July 29), "India's Flipkart raises \$1 billion in fresh funding," *The Wall Street Journal*; Fatima, F. (2014), "Flipkart-Myntra: From a merger to an acquisition," *International Journal of Management and International Business Studies* 4: 71–84; Kakroo, U. (2012, July), "E-commerce in India: Early birds, expensive worms," *McKinsey & Co.*; and various pages at www.flipkart.com.

MiniCase 20

Alibaba—China's Ecommerce Giant: Challenging Amazon?

TODAY, ALIBABA GROUP is the largest Chinese ecommerce company. In the original Arabic tale of *Ali Baba and the Forty Thieves*, Ali Baba, the poor woodcutter, opened the cave with hidden treasure by calling out the magic words “Open Sesame.” Alibaba’s founder selected the name to open up opportunities for small Chinese manufacturers to sell their goods around the world, with the hope of finding treasures for Alibaba’s users and shareholders. Today, Alibaba is a family of ecommerce businesses, which *The Wall Street Journal* described as “comparable to eBay, Amazon, and PayPal all rolled into one, with a stake in Twitter-like Weibo thrown in to boot.”¹ The Alibaba Group comprises four primary portals: Taobao, Tmall, Alibaba.com, and Aliyun (now AliCloud). Hundreds of millions of users access the sites, and millions of businesses rely on the portals to connect them with potential buyers. Taobao is Alibaba’s flagship online marketplace, a consumer-to-consumer retail platform with 7 million sellers offering more than 800 million items.

Just like Ali Baba in the folk tale, Alibaba had humble beginnings. In 1999, a former English teacher named Jack Ma started the company with a team of 18 in his apartment in Hangzhou, a city some 100 miles southwest of Shanghai. His timing couldn’t have been better, as the internet was just beginning to take hold in China. Since then, China has experienced explosive growth in internet users (see Exhibit MC20.1). By 2017, China’s internet users had grown to more than 720 million. Alibaba rode this wave of exponential growth to major success. In comparison, the United States has some 286 million internet users (less than 40 percent of China’s total).

The internet penetration rate, shown in the dotted line in Exhibit MC20.1, follows a typical S-shaped growth function, indicating that internet usage in China seems to be maturing. Nonetheless, given the still relatively low volume of online transactions in comparison to China’s total commerce, significant growth in per capita spending online is expected. In 2016, China’s ecommerce totaled about \$900 billion in sales. That



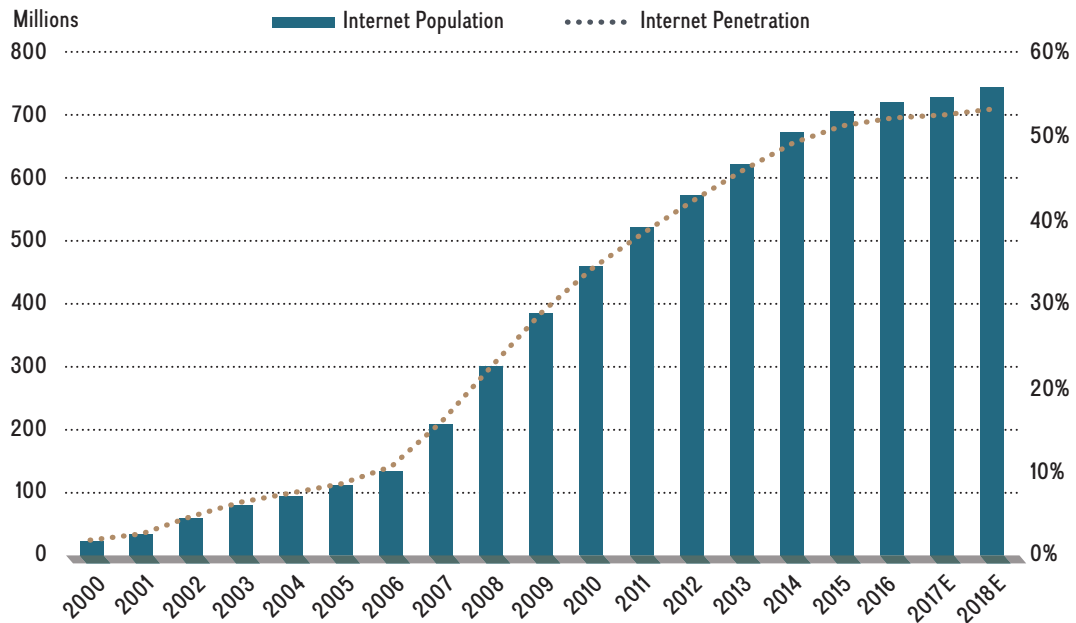
Jack Ma, a Hangzhou, China, native, is the founder and executive chairman of Alibaba Group. Alibaba had the most successful initial public offering (IPO) ever (listed on NYSE), surpassing a valuation of over \$230 billion on its first day of trading, September 19, 2014. By fall 2017, Alibaba’s market cap was some \$437 billion, making it one of the largest tech firms globally (and almost double its IPO valuation).

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year on Singles Day (11/11), the biggest annual online sales event in China, Alibaba alone achieved close to \$18 billion in sales, 20 percent of the total!

Initially, Alibaba’s website was a business-to-business (B2B) platform where China’s small and medium-sized businesses could showcase their products to buyers around the world. Alibaba was not the first company to explore opportunities in introducing China’s manufacturing to global demand, but it was the first to do so online. In its first year of operation, Alibaba signed up new members at a rate of 1,200 per day. By 2002, the young startup was

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EXHIBIT MC20.1 / China's Internet Users (millions) and Internet Penetration Rate (in percent), 2000–2018E

SOURCE: Depiction of data from "China Internet Users," <http://www.internetlivestats.com/internet-users/china/> (data for years 2017e and 2018e are estimates).

already profitable. By 2012, Alibaba facilitated transactions in nearly every country around the world.

Alibaba's Business Model and IPO

Exclusively a trading platform for third-party vendors, Alibaba, unlike Amazon, does not hold or own any inventory. Alibaba's main source of revenue is the transaction fees, listing fees, and ad revenues it generates from more than 10 million active sellers across its marketplaces. This asset-light model means the company has more room to push down prices on its platform by reducing transaction costs for its sellers. While both Alibaba and Amazon focus on a cost-leadership strategy, its asset-light model could thus turn out to be a competitive advantage for the Chinese firm.

On September 19, 2014, Alibaba went public on the New York Stock Exchange (NYSE). It had the most successful initial public offering ever, surpassing a stock market valuation of over \$230 billion on its first day of trading. By fall 2017, its market cap stood at a record high of \$437 billion, making it one of the most valuable tech companies globally. In comparison,

Amazon's market cap was some \$465 billion at the same time.

Yet, Alibaba's market presence is still predominantly in China. In 2017, Alibaba employed around 50,000 people, had \$23 billion in revenues, and remained highly profitable, capturing more than 50 percent of its revenues as profits. In the same year, Alibaba's Chinese marketplaces reported sales of some \$550 billion.

In a survey of U.S. internet shoppers, almost 9 out of 10 had never heard of Alibaba. Jack Ma, however, intends to change this perception. After meeting with President Donald J. Trump in early 2017, Ma promised that Alibaba would help lead at least 1 million small- and medium-sized businesses in the United States to its various online platforms, as well as offer global logistics expertise to help sell these businesses' goods in China.

Alibaba vs. U.S. Ecommerce Giants

To grow its business in China, Alibaba followed a strategy of related diversification by opening the C2C (consumer-to-consumer) website Taobao and later its

more popular B2C (business-to-consumer) website Tmall, and a host of other services such as Alipay, Alisoft, and cloud services. The other players in global ecommerce that were big during the 1990s, mainly the U.S. companies eBay and Amazon, decided to enter China via acquisitions.

Started in 1995, eBay entered the Chinese market in 2003 by acquiring EachNet for \$180 million. EachNet was started in Shanghai in 1999 by two Chinese entrepreneurs who had MBA training in the United States. It was designed as an auctioning platform to function very much like eBay. Early on, EachNet was the dominant force in China's online C2C market with close to 85 percent market share and 2 million users. Even when Alibaba launched its C2C website Taobao, completely free for sellers, the dominant position of EachNet, which charged a listing and transaction fee, did not erode. Problems mounted in 2004, however, when eBay decided to shut down EachNet's home-grown technology platform and move it to eBay's global platform. As EachNet's Chinese users migrated to the global platform, EachNet started losing market share in China. Its web pages loaded more slowly than those of its rivals because they now had to pass through the Chinese government's (internet) firewall (censoring software and other controls). Moreover, eBay's website features and user experience made it difficult for most of its Chinese users to navigate.

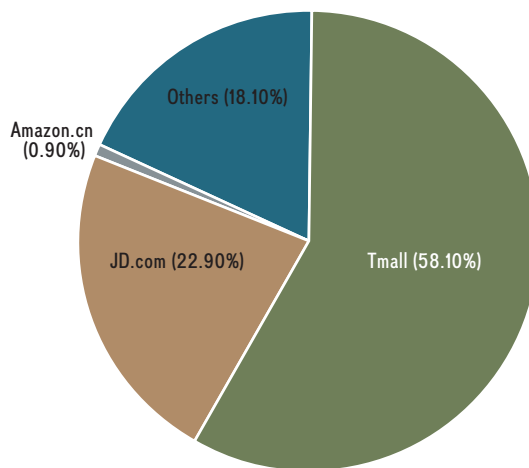
Alibaba was quick to react to this lapse by eBay; it launched features designed for a native Chinese audience. The instant messaging application Aliwangwang and Alipay, the escrow management services to facilitate online transactions, were instant hits with both sellers and buyers. By 2005, Alibaba's Taobao had 60 percent market share, while EachNet had fallen to a mere 30 percent (from 85 percent a few years prior). By 2006, eBay decided to shut down EachNet. Commenting on Alibaba's competition with eBay, founder Ma noted, "eBay may be a shark in the ocean, but I am a crocodile in the Yangtze River. If we fight in the ocean, we lose, but if we fight in the river, we win."²

Although Amazon is by far the leading ecommerce company in the United States (50 cents of every dollar spent online is spent there), its entry strategy into China parallels eBay's attempts. Amazon also entered China via acquisition. It bought Joyo.com, then the largest online bookstore in China, for \$75 million. It soon expanded Joyo.com (now Amazon.cn) product offerings. However, local players in China quickly labeled Amazon.cn as an expensive Western choice in comparison to low-cost local alternatives. By 2016, Amazon

EXHIBIT MC20.2 /

Market Share of B2C Companies in China, 2016

SOURCE: Depiction of data from Statista.com.



held an abysmal 1 percent market share in China (see Exhibit MC20.2). In what appeared to be a surrender, Amazon set up an online store on Alibaba's Tmall!

Challenges for Alibaba Going Forward

Looking ahead, Jack Ma and Alibaba are facing several internal and external challenges. Alibaba delivered slower than anticipated growth. The company also reorganized its operation by folding its consumer sites Taobao and Tmall into one business unit with group-buying site Juhuasuan. Alibaba also continues to heavily invest in expanding beyond the Chinese market to become a truly global player.

Alibaba invests heavily in cloud computing to compete more effectively with Amazon's AWS, the world's leader in cloud computing. Alibaba also spent almost \$5 billion to buy a 20 percent stake in Suning, China's largest electronics retailer. This should allow Alibaba to compete more effectively with its domestic rival JD.com, which is especially strong in electronics. JD.com, China's number-two ecommerce company, recently made waves by deploying drones for deliveries of online purchases, especially in remote areas. JD.com also plans to deploy larger drones that can carry up to 1 ton of payload in the near future, which it already tested successfully. To keep JD.com at bay, Alibaba is creating a retail presence throughout China—much

as Amazon is doing in the United States—to facilitate pick up and return of merchandise.

Since Alibaba is still mainly focused on the Chinese market, facilitating ecommerce transactions to consumers, it was hit hard by China's slowing economy. Moreover, the Chinese government decided to devalue its currency (the yuan), which made international products such as Nike running shoes and Procter & Gamble consumer products such as Tide much more expensive for Chinese consumers. This, in turn, is hurting Alibaba's sales. Moreover, some of Alibaba's domestic rivals, including JD.com, Tencent, Baidu, and WeChat, are getting much stronger, especially on mobile platforms. With its instant messaging app and mobile payment options, WeChat (owned by Tencent), in particular, is outperforming Alibaba on mobile platforms. WeChat has aspirations to morph into a global mobile platform. With 1 billion users worldwide, it is one of the most popular mobile apps in China and also globally.

Offering and facilitating the sales of counterfeit products is another big problem for Alibaba. Being an open online marketplace, it allows anyone to use its platform. The continued problem of counterfeits has led to Alibaba's being put on the United States Trade Representative (USTR) blacklist of notorious marketplaces (again), because the company has failed to keep counterfeiting and piracy levels in check. Alibaba is also in the middle of an investigation by the U.S. Securities and Exchange Commission about its accounting practices. As Alibaba looks to expand its services outside of ecommerce and China, Jack Ma needs to gear up to face new challenges.

DISCUSSION QUESTIONS

1. Why did eBay lose out to Alibaba in China? What lessons can be learned for non-Chinese internet (technology) companies?
2. How was Alibaba able to become the most successful ecommerce company in China? Think about standards, network effects, and the crossing-the-chasm framework to inform your reasoning.
3. Apply a SWOT analysis to Alibaba. Use the results to make some recommendations to Alibaba's CEO.
4. Apply the integration-responsiveness framework to determine:
 - a. Which global strategy position you would recommend Alibaba to pursue when attempting to create a stronger foothold in the United States. Explain why.
 - b. Which global strategy positions you would recommend U.S. ecommerce companies such as eBay, Amazon, and others to pursue when competing in China. Explain why.

Endnotes

1. "China changes won't face Alibaba," *The Wall Street Journal*, July 5, 2013.
2. As quoted in: "Standing up to a giant," *Forbes*, April 25, 2005.

Sources: A detailed and in-depth overview of Alibaba, its genesis and growth, is the insightful book by Clark, D. (2016), *Alibaba: The House That Jack Ma Built* (Ecco: New York). Other sources: Purnell, N. (2016, Nov. 18), "Jeff Bezos invests billions to make Amazon a top e-commerce player in India," *The Wall Street Journal*; Baskin, B., and L. Lin (2017, May 23), "Chinese online retailer JD.com is developing heavy-duty delivery drones," *The Wall Street Journal*; "China's internet giants go global," *The Economist*, April 20, 2017; Knutson, R., and L. Stevens (2017, Jan. 9), "Alibaba's Jack Ma: China-U.S. relationship should be 'more friendly,'" *The Wall Street Journal*; Tan, H. (2016, Dec. 21), "US puts Alibaba's Taobao website back in its list of 'notorious marketplaces,'" *CNBC*; Dou, E. (2016, Nov. 11), "Swinging singles day: Alibaba holiday drives shoppers in China," *The Wall Street Journal*; Osawa, J., and E. Dou (2015, June 23), "Alibaba stumbles in U.S. market," *The Wall Street Journal*; "Alibaba Group FY 2016-17 results," http://www.alibabagroup.com/en/news/press_pdf/p170518.pdf; company overview, news on Alibaba.com; Chu, K., and G. Wong (2015, Aug. 17), "Alibaba faces fresh threat from rivals," *The Wall Street Journal*; Wong, G., and C. Dulaney (2015, Aug. 2), "Reality hits Alibaba's results," *The Wall Street Journal*; "Clicks to bricks," *The Economist*, August 15, 2015; Mishkin, S. (2014, Oct. 29) "Amazon's ventures in China are raising concerns at home," *The Financial Times*; Demos, T., and J. Osawa (2014, Sept. 19), "Alibaba debut makes a splash," *The Wall Street Journal*; "Alibaba: The world's greatest bazaar," *The Economist*, March 23, 2013; "E-commerce in China: The Alibaba phenomenon," *The Economist*, March 23, 2013; "Microsoft considered building e-commerce market," *Fox Business*, June 2013; "Yahoo's Marissa Mayer hits one-year mark," *The Wall Street Journal*, July 15, 2013; "Yahoo's ad struggles persist," *The Wall Street Journal*, April 16, 2013; "How Taobao bested eBay in China," *Financial Times*, March 12, 2012; "How eBay failed in China," *Forbes*, September 12, 2010; "How eBay lost the China market," *Global Times*, August 10, 2009; "E-commerce with Chinese characteristics," *The Economist*, November 15, 2007; and "The Jack who would be king," *The Economist*, August 24, 2000.

MiniCase 21

HP's Boardroom Drama and Divorce

IN RECENT YEARS, Hewlett-Packard (HP) lost its rank among the largest technology companies in the world. It started the 2010s as one of the largest, with revenues north of \$127 billion at its peak in 2011. In 2014 (with revenues of some \$111 billion), HP was still in the top five in size. Late in 2015 it became harder to keep score, because the company split into two companies, each going their own way. However, if you combine the 2016 revenues of HP and HPE, you are now south of \$100 billion.

Decline in revenue was not HP's most difficult problem during this period. Worse was the huge erosion in shareholder value, which was much more dramatic and which we will discuss soon. The company's decline is in sharp contrast to most of its history. Indeed, HP was once so successful that it was featured as one of a handful of visionary companies in the business bestseller *Built to Last* (published in 1994). These select companies outperformed the stock market by a wide margin over several decades. *Built to Last* opens with a quote by HP's co-founder Bill Hewlett:

Hewlett passed away in 2001. Much has changed at HP since then. Within the 18 months from April 2010 to November 2012, HP's market value dropped by almost 80 percent, wiping out \$82 billion in shareholder wealth. Over the longer term, from early 2010 until summer 2015, HP's stock price declined by 42 percent, while the tech-heavy NASDAQ-100, containing many firms that compete with HP, rose by 143 percent. This marks a whopping 185 percentage points difference in performance! It turns out that a perfect storm of corporate governance problems, combined with repeated ethical shortcomings, had been brewing at HP for a decade. The result: a sustained competitive disadvantage.

This development is even more astonishing given that, at one point, HP was much admired for its corporate culture—known as “the HP Way.” The core values of the HP Way include business conducted with “uncompromising integrity,” as well as “trust and respect for individuals,” among others (see Exhibit MC21.1)



Meg Whitman, CEO of Hewlett Packard Enterprise. At the end of 2017, Whitman announced that she will be stepping down as CEO in early 2018.

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The HP Way guided the company since its inception in 1938, when it was founded with some \$500 of initial investment in Dave Packard's garage in Palo Alto, California. As one of the world's most successful technology companies (think laser printing), HP initiated the famous technology cluster now known as Silicon Valley. Over the past decade, however, HP's board of directors—a group of individuals that is supposed to represent the interests of the firm's shareholders and oversee the CEO—seemed to forget the HP Way as it violated its core values time and time again. In the process, HP's board of directors acted out a drama rivaling *House of Cards*, with the season finale not yet in sight.

The first season of the drama “aired” in 2006. The online technology site CNET published an article

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EXHIBIT MC21.1 / The HP Way

We have trust and respect for individuals.

We approach each situation with the belief that people want to do a good job and will do so, given the proper tools and support. We attract highly capable, diverse, innovative people and recognize their efforts and contributions to the company. HP people contribute enthusiastically and share in the success that they make possible.

We focus on a high level of achievement and contribution.

Our customers expect HP products and services to be of the highest quality and to provide lasting value. To achieve this, all HP people, especially managers, must be leaders who generate enthusiasm and respond with extra effort to meet customer needs. Techniques and management practices which are effective today may be outdated in the future. For us to remain at the forefront in all our activities, people should always be looking for new and better ways to do their work.

We conduct our business with uncompromising integrity.

We expect HP people to be open and honest in their dealings to earn the trust and loyalty of others. People at every level are expected to adhere to the highest standards of business ethics and must understand that anything less is unacceptable. As a practical matter, ethical conduct cannot be assured by written HP policies and codes; it must be an integral part of the organization, a deeply ingrained tradition that is passed from one generation of employees to another.

We achieve our common objectives through teamwork.

We recognize that it is only through effective cooperation within and among organizations that we can achieve our goals. Our commitment is to work as a worldwide team to fulfill the expectations of our customers, shareholders and others who depend upon us. The benefits and obligations of doing business are shared among all HP people.

We encourage flexibility and innovation.

We create an inclusive work environment which supports the diversity of our people and stimulates innovation. We strive for overall objectives which are clearly stated and agreed upon, and allow people flexibility in working toward goals in ways that they help determine are best for the organization. HP people should personally accept responsibility and be encouraged to upgrade their skills and capabilities through ongoing training and development. This is especially important in a technical business where the rate of progress is rapid and where people are expected to adapt to change.

SOURCE: Hewlett-Packard Alumni Association, www.hpalumni.org/hp_way.htm

on HP's strategy. Quoting an anonymous source, the article disclosed sensitive details that could have come only from one of the directors or senior executives at HP. Eager to discover the identity of the leaker, Patricia Dunn, then chair of the board, launched a covert investigation. She hired an outside security firm to conduct surveillance on HP's board members, select employees, and even some journalists. Although it is common for companies to monitor phone and computer use of their employees, HP's investigation went above and beyond. The private investigators used an illegal spying technique called "pretexting" (impersonating the targets) to obtain phone records by contacting telecom service providers. The security firm obtained some 300 telephone records covering mobile, home, and office phones of all directors (including Dunn), nine journalists, and several HP employees. Not to leave anything to chance, the security firm also obtained phone records of the spouses and even the children of

HP board members and employees. The firm also conducted physical surveillance of the suspected leaker—board member George Keyworth—and his spouse, as well as two other directors.

In a May 2006 board meeting, Dunn presented the evidence gathered, implicating Keyworth as the source of the leak. Dunn's disclosure of the investigation infuriated HP director Thomas Perkins, a prominent venture capitalist, so much that he resigned on the spot. Perkins called the HP-initiated surveillance "illegal, unethical, and a misplaced corporate priority."² Perkins also forced HP to disclose the spying campaign to the Securities and Exchange Commission (and thus the public) as his reason for resigning. Dunn and Keyworth were dismissed from the board along with six senior HP managers. Despite the boardroom drama, HP came out unscathed financially, largely due to the superior performance of then-CEO Mark Hurd.

Hurd was appointed Hewlett-Packard's CEO in the spring of 2005. He began his business career 25 years earlier as an entry-level salesperson with NCR, a U.S. technology company best known for its bar code scanners in retail outlets and automatic teller machines (ATMs). By the time Hurd worked his way up to the role of CEO at NCR, he had earned a reputation as a low-profile, no-nonsense manager focused on flawless strategy execution. When he was appointed HP's CEO, industry analysts praised its board of directors for its decision. Investors hoped that Hurd would run an efficient and lean operation at HP and return the company to its former greatness and, above all, profitability.

Hurd did not disappoint. By all indications, he was highly successful at the helm of HP. The company became number one in desktop computer sales and increased its lead in inkjet and laser printers to more than 50 percent market share. Through significant cost-cutting and streamlining measures, Hurd turned HP into a lean operation. For example, he oversaw large-scale layoffs and a pay cut for all remaining employees as he reorganized the company. Wall Street rewarded HP shareholders with an almost 90 percent stock price appreciation during Hurd's tenure, outperforming broader stock market indices by a wide margin.

Yet, in the summer of 2010, HP aired the second season of its boardroom soap opera. The HP board found itself caught between a rock and a hard place, with no easy options in sight. Jodie Fisher, a former adult-movie actor, filed a lawsuit against Hurd alleging sexual harassment. As an independent contractor, Fisher had worked as a hostess at HP-sponsored events. In this function, she had screened attending HP customers and personally ensured that Hurd spent time with the most important ones. With another ethics scandal looming despite Hurd's stellar financial results for the company, HP's board of directors forced him to resign. He left HP in August 2010 with an exit package worth \$35 million.

The third season of HP's boardroom drama began in the fall of 2010 when HP announced Leo Apotheker as its new CEO. Apotheker, who came to HP after being let go from the German enterprise software company SAP, proposed a new corporate strategy for HP. He suggested that the company focus on enterprise software solutions and spin off its low-margin consumer hardware business. HP's consumer hardware business resulted from the \$25 billion acquisition of Compaq during the tumultuous tenure of CEO Carly Fiorina, prior to Mark Hurd. The hardware business had grown to 40 percent of HP's total revenues. Under Apotheker,

HP also exited the mobile device industry, most notably tablet computers. Many viewed this move as capitulating to Apple's dominance.

As part of his new corporate strategy, Apotheker was eager to make a high-impact acquisition to put his strategic vision of HP as a software and service company into action. He ended up acquiring the British software company Autonomy for \$11 billion, which analysts saw as grossly overvalued. Shortly thereafter, HP took an almost \$9 billion writedown due to alleged "accounting inaccuracies" at Autonomy. HP's stock went into free fall. During Apotheker's short 11 months at the helm of HP, the share price dropped by almost 50 percent. HP's due diligence process by the board was clearly flawed when acquiring Autonomy. The process itself had been truncated. Moreover, the HP board did not heed the red flags thrown up by Deloitte, Autonomy's auditor. Indeed, a few days before the Autonomy acquisition was finalized, Deloitte auditors asked to meet with the board to inform them about a former Autonomy executive who accused the company of accounting irregularities. Deloitte also added that had it investigated the claim and did not find any irregularities.

Perhaps most problematic, the board fell victim to groupthink, rallying around Apotheker as CEO and Ray Lane, the board chair, who strongly supported him. In the wake of the Hurd ethics scandal, an outside recruiting firm had proposed Apotheker as CEO and Lane as the new chair of HP's board of directors. The full board never met either of the men before hiring them into key strategic positions! The HP board of directors experienced a major shakeup after the Hurd ethics scandal and then again after the departure of Apotheker. Lane stepped down as chair of HP's board in the spring of 2013 but remains a director.

After Apotheker was let go, HP did not conduct a search for its next CEO. Instead, in the fall of 2011, the board appointed one of its directors, Meg Whitman, as CEO because the board members were "too exhausted by the fighting."³ Whitman had been the CEO at eBay, was appointed to HP's board of directors in 2011, and was a director when the Autonomy acquisition was approved. In an effort to regain competitiveness Whitman cut 55,000 jobs.

As noted above, in 2015 HP split into two firms, one focusing on consumer hardware (PCs and printers) and called HP Inc. (\$48 billion in 2016 revenues), and the other on business equipment and services called Hewlett Packard Enterprise (\$50 billion in 2016 revenues). This corporate strategy move is very similar to what Apotheker had suggested three years earlier and similar

to what IBM, one of HP's main rivals, had undertaken a decade earlier. Whitman remained CEO of the new Hewlett Packard Enterprise, which is considered to have higher growth potential than the low-margin computer hardware business. By 2017, both stand-alone companies—Hewlett Packard Enterprise and HP—were performing decently. Indeed, Hewlett Packard Enterprise outperformed the tech-heavy NASDAQ-100 index over the past few years, while old-line HP Inc. performed roughly at the same level as the broader technology market. Both companies have avoided major boardroom drama in recent years.

DISCUSSION QUESTIONS

1. Who is to blame for HP's shareholder-value destruction—the CEO, the board of directors, or both? What recourse, if any, do shareholders have?
2. Why did HP split itself into two firms, a move that was rejected just three years earlier? Do you think the corporate strategy move of splitting the "old" HP into two companies (HP Inc. and Hewlett Packard Enterprise, HPE) will create shareholder value? Why or why not? Which of the two companies would you expect to be the higher performer? Why?
3. You are brought in as a corporate governance consultant or a business ethics consultant by the board of directors (of either HP or HPE). What recommendations would you give the board? How would you go about implementing them? Be specific.
4. Discuss the general lessons in terms of corporate governance and business ethics that can be drawn from this MiniCase.

Endnotes

1. "Suspicious and spies in Silicon Valley," *Newsweek*, September 17, 2006.
2. "How Hewlett-Packard lost its way," *CNN Money*, May 8, 2012.

Sources: King, R. (2017, Feb. 22), "HP revenue grows again on PC rebound," *The Wall Street Journal*; King, R. (2016, July 24), "Dell, HP take opposite tacks amid roiling tech market," *The Wall Street Journal*; "As H-P split nears, bosses tick off a surgery checklist," *The Wall Street Journal*, June 30, 2015; "Split today, merge tomorrow," *The Economist*, October 7, 2014; "Inside HP's missed chance to avoid a disastrous deal," *The Wall Street Journal*, January 21, 2013; "The HP Way out," *The Economist*, April 5, 2013; "How Hewlett-Packard lost its way," *CNN Money*, May 8, 2012; "HP shakes up board in scandal's wake," *The Wall Street Journal*, January 21, 2011; "HP CEO Mark Hurd resigns after sexual harassment probe," *The Huffington Post*, August 6, 2010; "The curse of HP," *The Economist*, August 12, 2010; "Corporate governance: Spying and leaking are wrong," *The Economist*, September 14, 2006; "Corporate governance: Pretext in context," *The Economist*, September 14, 2006; Packard, D. (1995), *HP Way: How Bill Hewlett and I Built Our Company* (New York: Collins); and Collins, J.C., and J.I. Porras (1994), *Built to Last: Successful Habits of Visionary Companies* (New York: HarperCollins).

MiniCase 22

UBS: A Pattern of Ethics Scandals

UBS WAS FORMED in 1997 when Swiss Bank Corp. merged with Union Bank of Switzerland. After acquiring Paine Webber, a 120-year-old U.S. wealth management firm, in 2000, and aggressively hiring for its investment banking business, UBS soon became one of the top financial services companies in the world and the biggest bank in Switzerland. Between 2008 and 2015, however, its reputation was severely tarnished by a series of ethics scandals. These scandals cost the bank billions of dollars in fines and lost profits, not to mention a severely diminished reputation. Even more important, they seem not to be isolated instances, but rather to suggest a troubling pattern.

Ethics Scandal No. 1: U.S. Tax Evasion

Swiss banks have long enjoyed a competitive advantage conferred by Swiss banking privacy laws that make it a criminal offense to share clients' information with any third parties. The exceptions are cases of criminal acts such as accounts being linked to terrorists or tax fraud. Merely not declaring assets to tax authorities (tax evasion), however, is not considered tax fraud. After the acquisition of Paine Webber, UBS entered into a qualified intermediary (QI) agreement with the Internal Revenue Service (IRS), the federal tax agency of the U.S. government. Like other foreign financial institutions under a QI agreement, UBS agreed to report and withhold taxes on accounts receiving U.S.-sourced income. This reporting is done on an aggregate basis to protect the identity of the non-U.S. account holders.

In mid-2008, it came to light that since 2000, UBS had actively participated in helping its U.S. clients evade taxes. To avoid QI reporting requirements, UBS' Switzerland-based bankers had assisted the U.S. clients to structure their accounts by divesting U.S. securities and setting up sham entities offshore to acquire non-U.S. account holder status. Aided by Swiss bank privacy laws, UBS successfully helped its U.S. clients conceal billions of dollars from the



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IRS. In addition, UBS aggressively marketed its “tax-saving” schemes by sending its Swiss bankers to the United States to develop clientele, even though those bankers never acquired proper licenses from the U.S. Securities and Exchange Commission (SEC) to do so.

The U.S. prosecutors pressed charges on UBS for conspiring to defraud the United States by impeding the IRS. In a separate suit, the U.S. government requested that UBS to reveal the names of 52,000 U.S. clients who were believed to be tax evaders. In February 2009, UBS paid \$780 million in fines to settle the charges. Although it initially resisted the pressure to turn over clients' information, citing Swiss bank privacy laws, UBS eventually agreed to disclose some 5,000 account details, including individual names, after intense negotiations involving officials from both countries. Clients left UBS in droves: Operating profit from the bank's wealth management division declined by 60 percent,

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or \$4.4 billion, in 2008 alone; it declined by another 17 percent, or \$504 million, in 2009.

The UBS case has far-reaching implications for the bank's wealth management business and the Swiss banking industry as a whole, especially its cherished bank secrecy. To close loopholes in the QI program and crack down on tax evasion in countries with strict bank secrecy traditions, President Obama signed into law the Foreign Account Tax Compliance Act (FATCA) in 2010. The law requires all foreign financial institutions to report offshore accounts and activities of their U.S. clients with assets over \$50,000, and to impose a 30 percent withholding tax on U.S. investments or to exit the U.S. business. Switzerland has agreed to implement the FATCA. The annual compliance cost for each Swiss bank is estimated to be \$100 million.

Ethics Scandal No. 2: Rogue Trader

On September 15, 2011, UBS announced that a rogue trader named Kweku Adoboli at its London branch had racked up an unauthorized trading loss of \$2.3 billion over three years. Nine days later, UBS CEO Oswald Grübel resigned "to assume responsibility for the recent unauthorized trading incident."¹ After more than a year of joint investigation by the U.K. and Swiss regulators, the case was concluded with findings that systems and controls at UBS were "seriously defective."² As a result, Adoboli, a relatively junior trader, had been able to take highly risky positions with vast amounts of money. More alarmingly, all three of Adoboli's desk colleagues admitted that they knew of his unauthorized trades. Moreover, Adoboli's two bosses had shown a relaxed attitude toward his breaching of daily trading limits.

UBS was fined \$47.6 million in late 2012. Adoboli was sentenced to seven years in prison, of which he served about half before being released in 2015. By summer 2017, he was still fighting his deportation order from Britain, where he had arrived at age 12 from his native Ghana to attend boarding school.

Ethics Scandal No. 3: LIBOR Manipulation

LIBOR, or the London Interbank Offered Rate, is the interest rate at which international banks based in London lend to each other. LIBOR is set daily: A panel of banks submits rates to the British

Bankers' Association based on their perceived unsecured borrowing cost; the rate is then calculated using a "trimmed" average, which excludes the highest and lowest 25 percent of the submissions. LIBOR is the most frequently used benchmark reference rate worldwide, setting prices on financial instruments worth about \$800 trillion, including mortgage rates, term loans, and many others.

UBS, as one of the panel banks, was fined \$1.5 billion in December 2012 by U.S., UK, and Swiss regulators for manipulating LIBOR submissions from 2005 to 2010. Besides accepting the fine, UBS pleaded guilty to U.S. prosecutors for committing wire fraud. During the stated period, UBS acted on its own or colluded with other panel banks to adjust LIBOR submissions to benefit UBS's own trading positions. In addition, during the second half of 2008, UBS instructed its LIBOR submitters to keep submissions low to make the bank look stronger. At least 40 people, including several senior managers at UBS, were involved in the manipulation. One major conviction was handed down.

In particular, 35-year-old Tom Hayes, a former UBS (and Citibank) trader, was sentenced to 14 years in prison for rigging the LIBOR. The jail sentence was much longer than what was expected. The judge presiding over the case stated that the court wanted to send a powerful message to banks around the world that financial crime will be severely punished and will no longer be settled with just a fine (paid by the bank). Hayes argues that he is the scapegoat for senior management failings: "I refute that my actions constituted any wrong doing. . . I wish to reiterate that my actions were consistent with those of others at senior levels. . . senior management was aware of my actions and at no point was I told that my actions could or would constitute any wrongdoing."³

In contrast, prosecutors maintained that Hayes was the mastermind behind a corrupt ring of traders and brokers globally, motivated by a desire to make his performance look stronger. Just a few years earlier, Hayes had been considered one of the most talented traders in the banking industry, whom Goldman Sachs tried to poach from UBS with the promise of a \$3 million signing bonus.

Following an appeal, in 2015, Hayes' sentence was reduced to 11 years. In his letters from prison, Tom Hayes states that he is being held basically in solitary confinement away from other inmates. Authorities indicate that this is done for his protection.

Ethics Scandal No. 4: UBS “Did It Again”

In 2015, in the wake of the LIBOR rigging scandal, the U.S. Department of Justice voided the \$1.5 billion settlement from 2012 with UBS, adding another \$200 million in fines. Perhaps more damaging, UBS pleaded guilty to allegations that its UBS traders (including Hayes) manipulated LIBOR. UBS had avoided prosecution in 2012 by agreeing to cooperate with authorities and promising not to engage in rate rigging and other illegal activities in the future. The Department of Justice now alleges that UBS violated the terms of the agreement and “did it again.” This time, prosecutors say that UBS manipulated foreign-exchange rates. In particular, UBS and other banks are accused of having colluded in moving foreign-exchange rates for their own benefit and to the detriment of their clients. The Justice Department views UBS as a “repeat offender,” especially in light of a 2011 settlement related to antitrust violations in the municipal-bond investments market.

DISCUSSION QUESTIONS

1. This MiniCase details several ethics scandals that occurred at UBS in recent years. What does that tell you about UBS?
2. Given repeated ethics failures at UBS, who is to blame? The CEO? The board of directors? The supervising managers? The individuals directly involved? Who should be held accountable? Is it sufficient just to fine the bank?
3. Given the information provided in this MiniCase, do you think that the 11-year jail sentence for Tom

Hayes was too harsh? Did he serve as a scapegoat? Note: The average jail sentence served for a person convicted of murder is 17 years in England and Wales.

4. What can UBS do to avoid ethics failures in the future and to repair its damaged reputation?

Endnotes

1. Bill Hewlett, HP co-founder, as quoted in Collins, J.C., and Porras, J.I., *Built to Last: Successful Habits of Visionary Companies*, New York: HarperCollins, 1994, 1.
2. “Suspensions and spies in Silicon Valley,” *Newsweek*, September 17, 2006.
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Sources: Raghavan, A. (2017, Mar. 24), “A rogue trader blames the system, but not all are persuaded,” *The New York Times*; UBS annual reports, various years; “How long do murderers serve in prison?” Data at: <https://fullfact.org/crime/how-long-do-murderers-serve-prison/>, accessed May 27, 2017; Topham, G. (2016, Jan. 3), “Libor fraudster Tom Hayes describes prison life in series of letters,” *The Guardian*, January 3; Bray, C. (2015, Dec. 21), “Court reduces ex-trader’s sentence in Libor case,” *The New York Times*; “Former trader Tom Hayes sentenced to 14 years for LIBOR rigging,” *The Wall Street Journal*, August 3, 2015; “Justice Department to tear up past UBS settlement,” *The Wall Street Journal*, May 14, 2015; “Goldman Sachs offered Tom Hayes \$3 million bonus to quit UBS,” *Bloomberg Businessweek*, May 28, 2015; “Demise of Swiss banking secrecy heralds new era,” *Financial Times*, May 19, 2013; “UBS ex-official gets 18 months in muni bond-rigging case,” *The Wall Street Journal*, July 24, 2013; “LIBOR rate-probe spotlight shines on higher-ups at Citigroup, other banks,” *The Wall Street Journal*, August 28, 2013; “Swiss and U.S. move forward on tax compliance,” *Swissinfo.ch*, June 21, 2012; “The LIBOR scandal: The rotten heart of finance,” *The Economist*, July 7, 2012; “UBS fined £30m over rogue trader,” *The Guardian*, November 26, 2012; “UBS fined £29.7m over rogue trader,” *Financial Times*, November 26, 2012; “Final notice to UBS AG,” *Financial Services Authority*, December 19, 2012; Cantley, B.G. (2011), “The U.B.S. case: The U.S. attack on Swiss banking sovereignty,” *Brigham Young University International Law & Management Review* 7 (Spring), available at SSRN: <http://ssrn.com/abstract=1554827>; “Rogue trader causes \$2 billion loss at UBS,” *Associated Press*, September 15, 2011; “Ending an era of Swiss banking secrecy: The facts behind FATCA,” *American Criminal Law Review*, September 18, 2011; “UBS enters into Deferred Prosecution Agreement,” The United States Department of Justice Release, February 18, 2009; “UBS to give 4,450 names to U.S.,” *The Wall Street Journal*, August 20, 2009; and “Tax haven banks and U.S. tax compliance,” United States Senate, July 17, 2008.

Case Analysis /

How to Conduct a Case Analysis

THE CASE STUDY is a fundamental learning tool in strategic management. We carefully wrote and chose the cases in this book to expose you to a wide variety of key concepts, industries, protagonists, and strategic problems.

In simple terms, cases tell the story of a company facing a strategic dilemma. The firms may be real or fictional in nature, and the problem may be current or one that the firm faced in the past. Although the details of the cases vary, in general they start with a description of the challenge(s) to be addressed, followed by the history of the firm up until the decision point, and then additional information to help you with your analysis. The strategic dilemma is often faced by a specific manager, who wonders what he or she should do. To address the strategic dilemma, you will use the AFI framework to conduct a case analysis as well as the strategic management tools and concepts provided in this textbook. After careful analysis, you will be able to formulate a strategic response and make recommendations about how to implement it.

Why Do We Use Cases?

Strategy is something that people learn by doing; it cannot be learned simply by reading a book or listening carefully in class. While those activities will help you become more familiar with the concepts and models used in strategic management, the only way to improve your skills in analyzing, formulating, and implementing strategy is to *practice*.

We encourage you to take advantage of the cases in this text as a “laboratory” in which to experiment with the strategic management tools you have been given, so that you can learn more about how, when, and where they might work in the “real world.” Cases are valuable because they expose you to a number and variety of situations in which you can refine your strategic management skills without worrying about

making mistakes. The companies in these cases will not lose profits or fire you if you miscalculate a financial ratio, misinterpret someone’s intentions, or make an incorrect prediction about environmental trends.

Cases also invite you to “walk in” and explore many more kinds of companies in a wider array of industries than you will ever be able to work at in your lifetime. With this strategy content, you will find MiniCases (i.e., shorter cases) about athletes (Michael Phelps), mass media and entertainment (Disney), technology (Apple), and entertainment (Cirque du Soleil), among others, as well as longer cases with complete financial data about companies such as Facebook, Tesla, McDonald’s, to name just a few. Your personal organizational experiences are usually much more limited, defined by the jobs held by your family members or by your own forays into the working world. Learning about companies involved in so many different types of products and services may open up new employment possibilities for you. Diversity also forces us to think about the ways in which industries (as well as people) are both similar and yet distinct, and to critically examine the degree to which lessons learned in one forum transfer to other settings (i.e., to what degree are they “generalizable”). In short, cases are a great training tool, and they are fun to study.

You will find that many of our cases are written from the perspective of the CEO or general manager responsible for strategic decision making in the organization. While you do not need to be a member of a top management team to utilize the strategic management process, these senior leaders are usually responsible for determining strategy in most of the organizations we study. Importantly, cases allow us to put ourselves “in the shoes” of strategic leaders and invite us to view the issues from their perspective. Having responsibility for the performance of an entire organization is quite different from managing a single project team, department, or functional area. Cases can help

you see the *big picture* in a way that most of us are not accustomed to in our daily, organizational lives. We recognize that most undergraduate students and even MBAs do not land immediately in the corporate boardroom. Yet having a basic understanding of the types of conversations going on in the boardroom not only increases your current value as an employee, but also improves your chances of getting there someday, should you so desire.

Finally, cases help give us a *long-term* view of the firms they depict. Corporate history is immensely helpful in understanding how a firm got to its present position and why people within that organization think the way they do. Our case authors (both the author of this book and authors of cases from respected third-party sources) have spent many hours poring over historical documents and news reports in order to recreate each company's heritage for you, a luxury that most of us do not have when we are bombarded on a daily basis with homework, tests, and papers or project team meetings, deadlines, and reports. We invite you not just to learn from but also to savor reading each company's story.

STRATEGIC CASE ANALYSIS. The first step in analyzing a case is to *skim it for the basic facts*. As you read, jot down your notes regarding the following basic questions:

- What company or companies is the case about?
- Who are the principal actors?
- What are the key events? When and where do they happen (in other words, what is the timeline)?

Second, go back and reread the case in greater detail, this time with a focus on *defining the problem*. Which facts are relevant and why? Just as a doctor begins by interviewing the patient ("What hurts?"), you likewise gather information and then piece the clues together in order to figure out what is wrong. Your goal at this stage is to identify the "symptoms" in order to figure out which "tests" to run in order to make a definitive "diagnosis" of the main "disease." Only then can you prescribe a "treatment" with confidence that it will actually help the situation. Rushing too quickly through this stage often results in "malpractice" (that is, giving a patient with an upset stomach an antacid when she really has the flu), with effects that range from unhelpful to downright dangerous. The best way to ensure that you "do no harm" is

to analyze the facts carefully, fighting the temptation to jump right to proposing a solution.

The third step, continuing the medical analogy, is to determine which analytical tools will help you to most accurately diagnose the problem(s). Doctors may choose to run blood tests or take an X-ray. In doing case analysis, we follow the steps of the *strategic management process*. You have any and all of the following models and frameworks at your disposal:

1. Perform an **external environmental analysis** of the:
 - Macro-level environment (PESTEL analysis).
 - Industry environment (e.g., Porter's five forces).
 - Competitive environment.
2. Perform an **internal analysis** of the firm using the resource-based view:
 - What are the firm's resources, capabilities, and competencies?
 - Does the firm possess valuable, rare, costly to imitate resources, and is it organized to capture value from those resources (VRIO analysis)?
 - What is the firm's value chain?
3. Analyze the firm's current **business-level** and **corporate-level** strategies:
 - Business-level strategy (product market positioning).
 - Corporate-level strategy (diversification).
 - International strategy (geographic scope and mode of entry).
 - How are these strategies being implemented?
4. Analyze the firm's **performance**:
 - Use both financial and market-based measures.
 - How does the firm compare to its competitors as well as the industry average?
 - What trends are evident over the past three to five years?
 - Consider the perspectives of multiple stakeholders (internal and external).
 - Does the firm possess a competitive advantage? If so, can it be sustained?

CALCULATING FINANCIAL RATIOS. Financial ratio analysis is an important tool for assessing the outcomes of a firm's strategy. Although financial performance is not the only relevant outcome measure, long-term profitability is a necessary precondition for

firms to remain in business and to be able to serve the needs of all of their stakeholders. Accordingly, at the end of this introductory module, we have provided a table of financial measures that can be used to assess firm performance (see Table 1).

All of the following aspects of performance should be considered, because each provides a different type of information about the financial health of the firm:

- Profitability ratios—how efficiently a company utilizes its resources.
- Activity ratios—how effectively a firm manages its assets.
- Leverage ratios—the degree to which a firm relies on debt versus equity (capital structure).
- Liquidity ratios—a firm’s ability to pay off its short-term obligations.
- Market ratios—returns earned by shareholders who hold company stock.

MAKING THE DIAGNOSIS. With all of this information in hand, you are finally ready to *make a “diagnosis.”* Describe the problem(s) or opportunity(ies) facing the firm at this time and/or in the near future. How are they interrelated? (For example, a runny nose, fever, stomach upset, and body aches are all indicative of the flu.) Support your conclusions with data generated from your analyses.

The following general themes may be helpful to consider as you try to pull all the pieces together into a cohesive summary:

- Are the firm’s value chain (primary and support) activities mutually reinforcing?
- Do the firm’s resources and capabilities fit with the demands of the external environment?
- Does the firm have a clearly defined strategy that will create a competitive advantage?
- Is the firm making good use of its strengths and taking full advantage of its opportunities?
- Does the firm have serious weaknesses or face significant threats that need to be mitigated?

Keep in mind that “problems” can be positive (how to manage increased demand) as well as negative (declining stock price) in nature. Even firms that are currently performing well need to figure out how to maintain their success in an ever-changing and highly competitive global business environment.

Formulation: Proposing Feasible Solutions

When you have the problem figured out (your diagnosis), the next step is to *propose a “treatment plan”* or solution. There are two parts to the treatment plan: the *what* and the *why*. Using our medical analogy: The *what* for a patient with the flu might be antiviral medication, rest, and lots of fluids. The *why*: antivirals attack the virus directly, shortening the duration of illness; rest enables the body to recuperate naturally; and fluids are necessary to help the body fight fever and dehydration. *The ultimate goal is to restore the patient to wellness.* Similarly, when you are doing case analysis, your task is to figure out *what* the leaders of the company should do and *why* this is an appropriate course of action. Each part of your proposal should be justifiable based on your analyses.

One word of caution about the formulation stage: By nature, humans are predisposed to engage in “local” and “simplistic” searches for solutions to the problems they face.¹ On the one hand, this can be an efficient approach to problem solving, because relying on past experiences (what worked before) does not waste time reinventing the wheel. The purpose of doing case analysis, however, is to *look past* the easy answers and to help us figure out not just what works (satisficing) but what might be the *best* answer (optimizing). In other words, do not just take the first idea that comes to your mind and run with it. Instead, write down that idea for subsequent consideration but then think about what other solutions might achieve the same (or even better) results. Some of the most successful companies engage in scenario planning, in which they develop several possible outcomes and estimate the likelihood that each will happen. If their first prediction turns out to be incorrect, then they have a Plan B ready and waiting to be executed.

Plan for Implementation

The final step in the AFI framework is to develop a plan for implementation. Under formulation, you came up with a proposal, tested it against alternatives, and used your research to support why it provides the best solution to the problem at hand. To demonstrate its feasibility, however, you must be able to explain *how to put it into action*. Consider the following questions:

1. *What activities need to be performed?* The value chain is a very useful tool when you need to figure out how different parts of the company are likely to be affected. What are the implications of your plan with respect to both primary activities (e.g., operations and sales/marketing/service) and support activities (e.g., human resources and infrastructure)?
2. *What is the timeline?* What steps must be taken first and why? Which ones are most critical? Which activities can proceed simultaneously, and which ones are sequential in nature? How long is your plan going to take?
3. *How are you going to finance your proposal?* Does the company have adequate cash on hand, or does it need to consider debt and/or equity financing? How long until your proposal breaks even and pays for itself?
4. *What outcomes is your plan likely to achieve?* Provide goals that are “SMART”: specific, measurable, achievable, realistic, and timely in nature. Make a case for how your plan will help the firm to achieve a strategic competitive advantage.

In-Class Discussion

Discussing your ideas in class is often the most valuable part of a case study. Your professor will moderate the class discussion, guiding the AFI process and asking probing questions when necessary. Case discussion classes are most effective and interesting when everybody comes prepared and participates in the exchange.

Actively listen to your fellow students; mutual respect is necessary in order to create an open and inviting environment in which people feel comfortable sharing their thoughts with one another. This does not mean you need to agree with what everyone else is saying, however. Everyone has unique perspectives and biases based on differences in life experiences, education and training, values, and goals. As a result, no two people will interpret the same information in exactly the same way. Be prepared to be challenged, as well as to challenge others, to consider the case from another vantage point. Conflict is natural and even beneficial as long as it is managed in constructive ways.

Throughout the discussion, you should be prepared to support your ideas based on the analyses you conducted. Even students who agree with you on the general steps to be taken may disagree on the order of importance. Alternatively, they may like your plan in

principle but argue that it is not feasible for the company to accomplish. You should not be surprised if others come up with an altogether different diagnosis and prescription. For better or worse, a good idea does not stand on its own merit—you must be able to convince your peers of its value by backing it up with sound logic and support.

Things to Keep in Mind while Doing Case Analysis

While some solutions are clearly better than others, it is important to remember that there is no single correct answer to any case. Unlike an optimization equation or accounting spreadsheet, cases cannot be reduced to a mathematical formula. Formulating and implementing strategy involves people, and working with people is inherently messy. Thus, the best way to get the maximum value from case analysis is to maintain an open mind and carefully consider the strengths and weaknesses of all of the options. Strategy is an iterative process, and it is important not to rush to a premature conclusion.

For some cases, your instructor may be able to share with you what the company actually did, but that does not necessarily mean it was the best course of action. Too often students find out what happened in the “real world” and their creative juices stop flowing. Whether due to lack of information, experience, or time, companies quite often make the most expedient decision. With your access to additional data and time to conduct more detailed analyses, you may very well arrive at a different (and better) conclusion. Stand by your findings as long as you can support them with solid research data. Even Fortune 500 companies make mistakes.

Unfortunately, to their own detriment, students sometimes discount the value of cases based on fictional scenarios or set some time in the past. One significant advantage of fictional cases is that everybody has access to the same information. Not only does this level the playing field, but it also prevents you from being unduly biased by actual events, thus cutting short your own learning process. Similarly, just because a case occurred in the past does not mean it is no longer relevant. The players and technology may change over time, but many questions that businesses face are timeless in nature: how to adapt to a changing environment, the best way to compete against other firms, and whether and how to expand.

Case Limitations

As powerful a learning tool as case analysis can be, it does come with some limitations. One of the most important for you to be aware of is that case analysis relies on a process known as *inductive reasoning*, in which you study specific business cases in order to derive general principles of management. Intuitively, we rely on inductive reasoning across almost every aspect of our lives. We know that we need oxygen to survive, so we assume that all living organisms need oxygen. Similarly, if all the swans we have ever seen are white, we extrapolate this to mean that all swans are white. While such relationships are often built upon a high degree of probability, it is important to remember that they are not empirically proven. We have in fact discovered life forms (microorganisms) that rely on sulfur instead of oxygen. Likewise, just because all the swans you have seen have been white, black swans do exist.

What does this caution mean with respect to case analysis? First and foremost, do not assume that just because one company utilized a joint venture to commercialize a new innovation, another company will be successful employing the same strategy. The first company's success may not be due to the particular organizational form it selected; it might instead be a function of its competencies in managing inter-firm relationships or the particularities of the external environment. Practically speaking, this is why the analysis step is so fundamental to good strategic management. Careful research helps us to figure out all of the potential contributing factors and to formulate hypotheses about which ones are most likely critical to success. Put another way, what happens at one firm does not necessarily generalize to others. However, solid analytical skills go a long way toward enabling you to make informed, educated guesses about when and where insights gained from one company have broader applications.

In addition, we have a business culture that tends to put on a pedestal high-performance firms and their leaders. Critical analysis is absolutely essential in order to discern the reasons for such firms' success. Upon closer inspection, we have sometimes found that their image is more a mirage than a direct reflection of sound business practices. Many business analysts have been taken in by the likes of Enron, WorldCom, and Bernie Madoff, only to humbly retract their praise when the company's shaky foundation crumbles. We selected many of the firms in these cases because of

their unique stories and positive performance, but we would be remiss if we let students interpret their presence in this book as a wholehearted endorsement of all of their business activities.

Finally, our business culture also places a high premium on benchmarking and best practices. Although we present you with a sample of firms that we believe are worthy of in-depth study, we would again caution you against uncritical adoption of their activities in the hope of emulating their achievements. Even when a management practice has broad applications, strategy involves far more than merely copying the industry leader. The company that invents a best practice is already far ahead of its competitors on the learning curve, and even if other firms do catch up, the best they can usually hope for is to match (but not exceed) the original firm's success. By all means, learn as much as you can from whomever you can, but use that information to strengthen your organization's *own* strategic identity.

Frequently Asked Questions about Case Analysis

1. *Is it OK to utilize outside materials?*

Ask your professor. Some instructors utilize cases as a springboard for analysis and will want you to look up more recent financial and other data. Others may want you to base your analysis on the information from the case only, so that you are not influenced by the actions actually taken by the company.

2. *Can I talk about the case with other students?*

Again, you should check with your professor, but many will strongly encourage you to meet and talk about the case with other students as part of your preparation process. The goal is not to come to a group consensus, but to test your ideas in a small group setting and revise them based on the feedback you receive.

3. *Is it OK to contact the company for more information?*

If your professor permits you to gather outside information, you may want to consider contacting the company directly. If you do so, it is imperative that you represent yourself and your school in the most professional and ethical manner possible. Explain to them that you are a student studying the firm and that you are seeking additional information, with your instructor's permission. Our experience is that some

companies are quite receptive to student inquiries; others are not. You cannot know how a particular company will respond unless you try.

4. *What should I include in my case analysis report?*

Instructors generally provide their own guidelines regarding content and format, but a general outline for a case analysis report is as follows: (1) analysis of the problem; (2) proposal of one or more alternative solutions; and (3) justification for which solution you believe is best and why. The most important thing

to remember is not to waste precious space repeating facts from the case. You can assume that your professor has read the case carefully. What he or she is most interested in is your analysis of the situation and your rationale for choosing a particular solution.

ENDNOTE

1. Cyert, R.M., and J.G. March (2001), *A Behavioral Theory of the Firm*, 2nd ed. (Malden, MA: Blackwell Publishers Inc.).

TABLE 1 / When and How to Use Financial Measures to Assess Firm Performance

Overview: We have grouped the financial performance measures into five main categories: Table 1a: Profitability: How profitable is the company? Table 1b: Activity: How efficient are the operations of the company? Table 1c: Leverage: How effectively is the company financed in terms of debt and equity? Table 1d: Liquidity: How capable is the business of meeting its short-term obligations as they fall due? Table 1e: Market: How does the company's performance compare to other companies in the market?		
Table 1a: Profitability Ratios	Formula	Characteristics
Gross margin (or EBITDA, EBIT, etc.)	(Sales – COGS) / Sales	Measures the relationship between sales and the costs to support those sales (e.g., manufacturing, procurement, advertising, payroll, etc.)
Return on assets (ROA)	Net income / Total assets	Measures the firm's efficiency in using assets to generate earnings
Return on equity (ROE)	Net income / Total stockholders' equity	Measures earnings to owners as measured by net assets
Return on invested capital (ROIC)	Net profits / Invested capital	Measures how effectively a company uses its total invested capital, which consists of two components: (1) shareholders' equity through the selling of shares to the public, and (2) interest-bearing debt through borrowing from financial institutions and bondholders.
Return on revenue (ROR)	Net profits / Revenue	Measures the profit earned per dollar of revenue
Dividend payout	Common dividends / Net income	Measures the percent of earnings paid out to common stockholders
Limitations	1. Static snapshot of balance sheet. 2. Many important intangibles not accounted for. 3. Affected by accounting rules on accruals and timing. One-time nonoperating income/expense. 4. Does not take into account cost of capital. 5. Affected by timing and accounting treatment of operating results.	

TABLE 1 / When and How to Use Financial Measures to Assess Firm Performance (continued)

Table 1b: Activity Ratios	Formula	Characteristics
Inventory turnover	COGS / inventory	Measures inventory management
Receivables turnover	Revenue / accounts receivable	Measures the effectiveness of credit policies and the needed level of receivables investment for sales
Payables turnover	Revenue / accounts payable	Measures the rate at which a firm pays its suppliers
Working capital turnover	Revenue / working capital	Measures how much working (operating) capital is needed for sales
Fixed asset turnover	Revenue / fixed assets	Measures the efficiency of investments in net fixed assets (property, plant, and equipment after accumulated depreciation)
Total asset turnover	Revenue / total assets	Represents the overall (comprehensive) efficiency of assets to sales
Cash turnover	Revenue / cash (which usually includes marketable securities)	Measures a firm's efficiency in its use of cash to generate sales
Limitations	Good measures of cash flow efficiency, but with the following limitations: 1. Limited by accounting treatment and timing (e.g., monthly/quarterly close) 2. Limitations of accrual vs. cash accounting	

TABLE 1 / When and How to Use Financial Measures to Assess Firm Performance (continued)

Table 1c: Leverage Ratios	Formula	Characteristics
Debt to equity	Total liabilities / total stockholders' equity	Direct comparison of debt to equity stakeholders and the most common measure of capital structure
Debt to assets	Total liabilities / total assets	Debt as a percent of assets
Interest coverage (times interest earned)	(Net income + Interest expense + Tax expense) / interest expense	Direct measure of the firm's ability to meet interest payments, indicating the protection provided from current operations
Long-term debt to equity	Long-term liabilities / total stockholders' equity	A long-term perspective of debt and equity positions of stakeholders
Debt to market equity	Total liabilities at book value / total equity at market value	Market valuation may represent a better measure of equity than book value. Most firms have a market premium relative to book value.
Bonded debt to equity	Bonded debt / stockholders' equity	Measures a firm's leverage in terms of stockholders' equity
Debt to tangible net worth	Total liabilities / (common equity – intangible assets)	Measures a firm's leverage in terms of tangible (hard) assets captured in book value
Financial leverage index	Return on equity / return on assets	Measures how well a company is using its debt
Limitations	Overall good measures of a firm's financing strategy; needs to be looked at in concert with operating results because 1. These measures can be misleading if looked at in isolation. 2. They can also be misleading if using book values as opposed to market values of debt and equity.	

TABLE 1 / When and How to Use Financial Measures to Assess Firm Performance (continued)

Table 1d: Liquidity Ratios	Formula	Characteristics
Current	Current assets / current liabilities	Measures short-term liquidity. Current assets are all assets that a firm can readily convert to cash to pay outstanding debts and cover liabilities without having to sell hard assets. Current liabilities are a firm's debt and other obligations that are due within a year.
Quick (acid-test)	(Cash + Marketable securities + Net receivables) / current liabilities	Eliminates inventory from the numerator, focusing on cash, marketable securities, and receivables.
Cash	(Cash + Marketable securities) / current liabilities	Considers only cash and marketable securities for payment of current liabilities.
Operating cash flow	Cash flow from operations / current liabilities	Evaluates cash-related performance (as measured from the statement of cash flows) relative to current liabilities.
Cash to current assets	(Cash + Marketable securities) / current assets	Indicates the part of current assets that are among the most fungible (i.e., cash and marketable securities).
Cash position	(Cash + Marketable securities) / total assets	Indicates the percent of total assets that are most fungible (i.e., cash).
Current liability position	Current liabilities / total assets	Indicates what percent of total assets the firm's current liabilities represent.
Limitations	Liquidity measures are important, especially in times of economic instability, but they also need to be looked at holistically along with financing and operating measures of a firm's performance. 1. Accounting processes (e.g., monthly close) limit efficacy of these measures when you want to understand daily cash position. 2. No account taken of risk and exposure on the liability side.	

TABLE 1 / When and How to Use Financial Measures to Assess Firm Performance (continued)

Table 1e: Market Ratios	Formula	Characteristics
Book value per share	Total stockholders' equity / number of shares outstanding	Equity or net assets, as measured on the balance sheet
Earnings-based growth models	$P = kE / (r - g)$, where E = earnings, k = dividend payout rate, r = discount rate, and g = earnings growth rate	Valuation models that discount earnings and dividends by a discount rate adjusted for future earnings growth
Market-to-book	(Stock price $\times$ Number of shares outstanding) / total stockholders' equity	Measures accounting-based equity
Price-earnings (PE) ratio	Stock price / EPS	Measures market premium paid for earnings and future expectations
Price-earnings growth (PEG) ratio	PE / earnings growth rate	PE compared to earnings growth rates, a measure of PE "reasonableness"
Sales-to-market value	Sales / (stock price $\times$ number of shares outstanding)	A sales activity ratio based on market price
Dividend yield	Dividends per share / stock price	Direct cash return on stock investment
Total return to shareholders	Stock price appreciation plus dividends	
Limitations	Market measures tend to be more volatile than accounting measures but also provide a good perspective on the overall health of a company when used holistically with the other measures of financial performance. 1. Market volatility/noise is the biggest challenge with these measures. 2. Understanding what is a result of a firm strategy/decision vs. the broader market is challenging.	

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FINANCIAL RATIOS USED IN CASE ANALYSIS	
	Formula
Profitability Ratios: “How profitable is the company?”	
Gross Margin (or EBITDA, EBIT, etc.)	$(\text{Sales} - \text{COGS}) / \text{Sales}$
Return on Assets (ROA)	$\text{Net Income} / \text{Total Assets}$
Return on Equity (ROE)	$\text{Net Income} / \text{Total Stockholders' Equity}$
Return on Invested Capital (ROIC)	$\text{Net Operating Profit After Taxes} / (\text{Total Stockholders' Equity} + \text{Total Debt} - \text{Value of Preferred Stock})$
Return on Revenue (ROR)	$\text{Net Profits} / \text{Revenue}$
Dividend Payout	$\text{Common Dividends} / \text{Net Income}$
Activity Ratios: “How efficient are the operations of the company?”	
Inventory Turnover	$\text{COGS} / \text{Inventory}$
Receivables Turnover	$\text{Revenue} / \text{Accounts Receivable}$
Payables Turnover	$\text{Revenue} / \text{Accounts Payable}$
Working Capital Turnover	$\text{Revenue} / \text{Working Capital}$
Fixed Asset Turnover	$\text{Revenue} / \text{Fixed Assets}$
Total Asset Turnover	$\text{Revenue} / \text{Total Assets}$
Cash Turnover	$\text{Revenue} / \text{Cash (which usually includes marketable securities)}$
Leverage Ratios: “How effectively is the company financed in terms of debt and equity?”	
Debt to Equity	$\text{Total Liabilities} / \text{Total Stockholders' Equity}$
Financial Leverage Index	$\text{Return on Equity} / \text{Return on Assets}$
Debt Ratio	$\text{Total Liabilities} / \text{Total Assets}$
Interest Coverage (Times Interest Earned)	$(\text{Net Income} + \text{Interest Expense} + \text{Tax Expense}) / \text{Interest Expense}$
Long-Term Debt to Equity	$\text{Long-Term Liabilities} / \text{Total Stockholders' Equity}$
Debt to Market Equity	$\text{Total Liabilities at Book Value} / \text{Total Equity at Market Value}$
Bonded Debt to Equity	$\text{Bonded Debt} / \text{Stockholders' Equity}$
Debt to tangible net worth	$\text{Total Liabilities} / (\text{Common Equity} - \text{Intangible Assets})$
Liquidity Ratios: “How capable is the company of meeting its short-term obligations?”	
Current	$\text{Current Assets} / \text{Current Liabilities}$
Quick (Acid-Test)	$(\text{Cash} + \text{Marketable Securities} + \text{Net Receivables}) / \text{Current Liabilities}$
Cash	$(\text{Cash} + \text{Marketable Securities}) / \text{Current Liabilities}$
Operating Cash Flow	$\text{Cash Flow from Operations} / \text{Current Liabilities}$
Cash to Current Assets	$(\text{Cash} + \text{Marketable Securities}) / \text{Current Assets}$
Cash Position	$\text{Cash} / \text{Total Assets}$
Current Liability Position	$\text{Current Liabilities} / \text{Total Assets}$
Market Ratios: “How does the company’s performance compare to other companies?”	
Book Value per Share	$\text{Total Stockholders' Equity} / \text{Number of Shares Outstanding}$
Earnings-Based Growth Models	$P = kE / (r - g)$, where E = Earnings, k = Dividend Payout Rate, r = Discount Rate, and g = Earnings Growth Rate
Market-to-Book	$(\text{Stock Price} \times \text{Number of Shares Outstanding}) / \text{Total Stockholders' Equity}$
Price-Earnings (PE) Ratio	$\text{Stock Price} / \text{EPS}$
Price-Earnings Growth (PEG) Ratio	$\text{PE} / \text{Earnings Growth Rate}$
Sales-to-Market Value	$\text{Sales} / (\text{Stock Price} \times \text{Number of Shares Outstanding})$
Dividend Yield	$\text{Dividends per Share} / \text{Stock Price}$
Total Return to Shareholders	$\text{Stock Price Appreciation} + \text{Dividends}$

